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# Can Aid Reform Institutions?

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## Can Aid Reform Institutions?

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**Abstract** Can aid reform institutions? The realities of foreign aid and the nature of aid-giving organizations are at odds with what we know about institutional change: that it is often gradual, path dependent, context specific, and contrary to notions of best practice in Western countries. Empirical analyses find no positive correlation between aid and better institutions or between aid and growth in GDP per capita. If aid cannot reform institutions, can aid avoid damaging institutions? Efforts to avoid the ill effects of damaging institutions by insulating aid projects or by relying on NGO's or beneficiary participation, have met with mixed success. Efforts to aid only those poorer countries that are already improving their institutions confront serious measurement problems. This paper calls for more experiments, better local information, more case studies of the institutional prerequisites for the implementation of high priority policies, and greater local capacity to design sustainable institutional reforms.

**Keywords** Foreign aid, institutional change, poverty reduction

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## Can Aid Reform Institutions?<sup>1</sup>

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### 1. Introduction

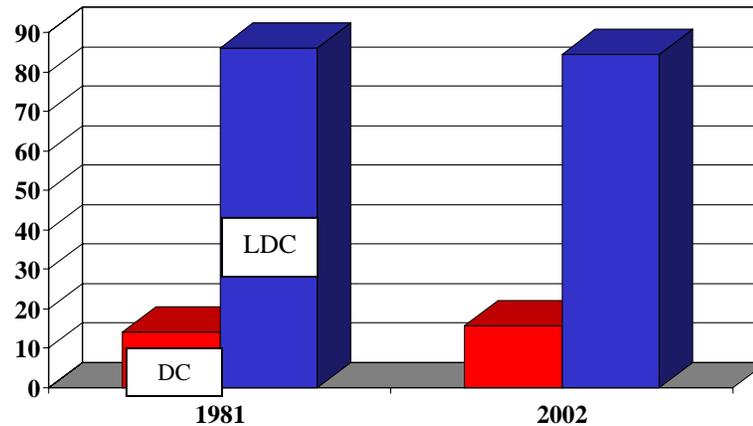
Since the end of World War II the foreign aid community has burgeoned. Annually, twenty one multilateral and 36 bilateral organizations are responsible for over \$150 billion in foreign aid, while thousands of private, international non-governmental organizations provide another \$ 10 billion (Table 1).<sup>2</sup> These aid giving organizations are dedicated to the proposition that underdevelopment can be eliminated and poverty eradicated. The World Bank mission statement is emblematic: “Our dream is a world free of poverty.” Yet the dreams, money, and good intentions of aid givers notwithstanding, most people in aid recipient countries still live in appalling poverty. If we define development to mean countries with per capita incomes in the World Bank’s high-income category (above \$9,076 in 2002) then most of the world’s population live in underdeveloped countries. This circumstance has changed little in recent decades as we can see in Graph One (World Bank 2002, 2003).

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<sup>1</sup> Preliminary work on this paper was done while visiting Stanford University’s Center for International Development in March 2004. Conversations with researchers at SCID and comments from participants in a SCID seminar have greatly clarified by ideas on this subject, and I owe a debt of gratitude to Roger Noll, as well as to Lee Benham, Avner Greif, Nick Hope, Douglass North, and Barry Weingast for their insights. My thanks also to SCID staff for their help and friendship and to participants in seminars at the Mercatus Center at George Mason University and the International Food Policy Research Institute. Errors and fuzzy thinking are my own fault of course.

<sup>2</sup> There were 17,428 international NGO’s in 2000, at least to judge from the number of headquarters (London School of Economics 2003).

Graph One: World Population Living in Developed (DC) or Less Developed (LDC) Countries, Percentages



Source: World Bank, World Development Reports, various. Developed is defined as countries ineligible to borrow from IBRD (the World Bank's window for loans on harder terms), above US\$9,076 in 2002.

Although there has been a reduction in absolute poverty, thanks largely to growth in China, few countries have graduated from underdevelopment. Progress has been especially slow for those at the bottom. The poorest three fifths of countries have had zero growth in income per capita since 1981 (Easterly 2002b). Disparity between rich and poor countries has increased. The disparity between rich and poor populations has decreased, thanks again to growth in China and to a lesser extent, India, but for reasons I discuss later, it is highly doubtful that China's success can be attributed to aid.<sup>3</sup>

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<sup>3</sup> Sala-I-Martin (2002) finds convergence in incomes when inequality is measured in terms of purchasing power and weighted by population because of the large proportion of people living in China who saw their incomes rise over the last decade. The disturbing stagnation of African economies explains why these countries account for over 95% of the world's poor (Sala-I-Martin 2002, p.39).

Table 1: Size of the Aid Community in 2003

Type of Aid Agency	Number	Assistance <sup>a</sup> 2003
<b>International Financial Institutions</b>	10	
African Development Bank		\$ 1,555
Asian Development Bank		\$ 3,826
European Development Bank		\$ 907
InterAmerican Development Bank		\$ 9,002
International Monetary Fund		\$ 1,187
World Bank (IBRD, IDA, IFC)		\$ 19,638
Other (Caribbean Development Bank, Council of Europe, Int'l Fund for Agric. Dev., Nordic Development Fund)		417
<b>Total IFIs</b>		<b>\$ 36,532</b>
<b>United Nations agencies</b> (UNDP, UNFPA, UNHCR, UNICEF, UNRWA, UNTA, WFP, Other UN)	7	
<b>Total UN</b>		<b>\$ 3,467</b>
<b>Other Multinational Aid Agencies</b>	4	
European Community		\$ 8,212
Global Environmental Facility		\$ 107
Montreal Protocol Fund		\$ 66
Arab Funds		\$ 202
<b>Total</b>		<b>\$ 8,587</b>
<b>Bilateral Aid<sup>b</sup></b>		
Development aid, OECD members of DAC <sup>c</sup>	22	\$ 90,391
Of which, Netherlands		5,027
United States		29,750
Debt reorganization		\$ 8,554
Of which, debt forgiveness		8,338
Development aid, non DAC members <sup>d</sup>	14	\$ 3,129 <sup>e</sup>
<b>Total</b>		<b>\$102,075</b>
<b>Grants by Private Voluntary Organizations</b>		<b>\$ 10,162</b>
<b>TOTAL ASSISTANCE</b>		<b>\$160,824</b>

<sup>a</sup> Concessional and non-concessional gross disbursements to developing countries (as defined by the OECD) with promotion of economic development as the goal at current prices converted to US dollars at current exchange rates.

<sup>b</sup> Includes grant and grant like contributions (including technical co-operation, development food aid, emergency and distress relief, contributions to NGOs, and administrative costs) and new development lending.

<sup>c</sup> Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, UK, US.

<sup>d</sup> Czech Republic, Estonia, Hungary, Iceland, Israel, Korea, Kuwait, Latvia, Lithuania, Poland, Saudi Arabia, Slovak Republic, Turkey, and United Arab Emirates. China also provides aid but does not disclose the amount.

<sup>e</sup> Net.

Sources: Calculated from OECD (2005, Tables 13, 17, and 33).

What causes some countries to be underdeveloped? In the 60 years since the Second World War ended the aid community embraced and discarded a number of different explanations, as I describe in Section 2. Currently (2004) institutional explanations are in vogue, as the following quotes suggest:

- “Addressing the challenge of building effective institutions is critical to the Bank’s mission of fighting poverty.” (World Bank 2002, p.iii)
- Sustainable and equitable development requires a democratic, modern and efficient state that promotes economic growth, establishes a regulatory framework conducive to the efficient functioning of markets, that guarantees a stable macroeconomic environment, that is capable of adopting social and economic policies appropriate for poverty reduction and environmental preservation, and that implements such policies in an efficient, transparent and accountable manner. In the development debate a consensus has formed that the quality of public institutions is an essential, and perhaps the most important ingredient for sustainable economic growth.” (InterAmerican Development Bank 2003, p.9).
- “Development interventions are more likely to succeed if they promote improvements in wider institutional competencies as well as in technical competencies” (Department for International Development 2003, p.5).

Institutional factors correlate strongly with growth, as I discuss in section 3, but this raises as many questions than it answers. How do institutions affect development, and how do you get well functioning institutions? The literature has only partly addressed these questions and there are many gaps in our understanding but some findings emerge from the new institutional economics (NIE) These findings challenge the proposition that aid can reform institutions, especially when we consider the nature of aid and of aid organizations (section 4). The empirical evidence also suggests that aid has had little measurable influence on institutions in recipient countries, although some challenge these conclusions. If aid cannot reform institutions can it avoid those institutions that could undermine aid efforts? In section 5, I consider efforts to insulate

aid projects from damaging institutional environments or to bypass damaging governments and conclude that they have mixed success, success that is vulnerable to institutional disequilibria over time. Greater selectivity is sensible under these circumstances, but our limited understanding of what constitutes meaningful institutional change in specific cases makes it hard for aid givers to know whether they are accurately measuring a country's institutional capacity to use aid effectively (section 5). I conclude in section 6 with some suggestions for alternative approaches: more experiments and greater use of markets; improving our knowledge of the institutional prerequisites and political circumstances that allow countries to implement reforms; and building competency inside and outside government.

## **2. What Causes Underdevelopment?**

In *The Elusive Quest for Growth*, Bill Easterly provides an insightful and entertaining account of the various explanations for underdevelopment that economists have proposed and the aid community has embraced over the years.<sup>4</sup> Most prominent among the justifications for foreign aid are: (i) under-investment or too little technological innovation; (ii) lack of education; and (iii) market-unfriendly

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<sup>4</sup> There are other explanations based on traits that defy or resist reform, such as geography (see, for example Gallup, et al. April 1998) or the so-called curse of natural resources (see papers cited in Wright and Czelusta 2003). These explanations leave little scope or rationale for foreign aid. The geographical explanation argues that countries are underdeveloped because they are cursed with dangerous diseases; high transport costs because they are landlocked, mountainous, or lack good ports; low agricultural productivity because their terrain is arid or prone to flooding or drought; or high population density on areas suitable for agriculture but not easily accessible for trade. Geographical explanations ignore the prior wealth of some of today's poor countries, such as Egypt or Persia, and the inhospitable conditions that once prevailed in some of today's wealthy countries, such as malaria in the Southern US or flooding and high population density in the Netherlands. The resource curse explanation argues that abundant and valuable natural resources like oil corrupt a country's governance and promote under-investment in other productive sectors. But this reasoning ignores successful resource rich countries such as the US, Australia, or Norway. The US, for example, dominated world petroleum production from the late 1800's until 1960 (Wright and Czelusta 2003, p.13).

macroeconomic policies.<sup>5</sup> Easterly shows how each of these justifications was adopted and discarded when they failed to deliver the promised growth.

It was reasonable to assume that investment, innovation, education, and sound macroeconomic policies could stimulate growth; they do promote growth in developed countries. But the assumption that these measures would function in every economy in the same way proved to be wrong. Reforms in developed countries set off a virtuous circle of changes that reinforce one another. But underdeveloped countries are trapped in a low-level equilibrium. Only if the root causes of that equilibrium are removed do reforms promote growth. Under-investment, lack of innovation, too little education, and bad policies may be proximate causes of underdevelopment, but they are not ultimate causes, and correcting them is not enough to move countries out of a low-level equilibrium trap.

Consider the case of education. Initial levels of secondary education in 1900 are correlated with current levels of GDP per capita, which has led some analysts to argue that human capital is more important than institutions in growth (Glaeser, et al. 2004). But increases in years of schooling of the labor force are not correlated with growth in GDP per worker in developing countries, except perhaps negatively (see Easterly 2002b, chapter 4, Prichett 1996).

As Easterly points out, the quality of education is higher in economies that provide incentives to invest in the future: “Students will apply themselves to their studies, parents will monitor the quality of education, and teachers will face pressure to teach” (Easterly 2002b, p.82). If incentives to invest in the future are low, educational quality will be poor and there will be under-investment in learning. There are many examples of

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<sup>5</sup> This discussion draws heavily on Easterly (2002b).

poor educational quality in developing countries: on any given day a third of all teachers in Uttar Pradesh, India are absent; 70 percent of students who completed grade 5 in Bangladesh are not minimally competent in writing; the 1994 Tanzania Primary School Leavers Examination found that four-fifths of students scored less than 13 percent correct in language or mathematics after seven years of schooling (World Bank 2004, p.112). Aid projects that fund investments in building schools, buying textbooks, training teachers, or reorganizing the ministry of education will not have much effect on learning or growth if parents and students expect low returns from schooling and teachers or administrators do not expect to be held accountable by the community, the polity, or the bureaucracy.

### **3. The Role of Institutions in Development**

Ultimately, as the education example shows, an economy's future rests on choices made by economic, political, and social actors, choices that are motivated by institutions. Institutions are the "humanly devised constraints that structure human interaction," and include formal constraints such as constitutions and laws and informal constraints such as norms, conventions and self-imposed codes of conduct (North 1990, p.3).<sup>6</sup> As North explains, institutions are the product of intentional human efforts to provide structure in an uncertain world, and are congruent with a society's dominant set of beliefs about how that world operates (North 2004). Successful market economies are characterized by institutions that (i) foster exchange by lowering transaction costs and encouraging trust, and (ii) stimulate state actors to protect property and individual rights rather than expropriate and exploit them (Shirley 2005 forthcoming).

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<sup>6</sup> Organizations differ from institutions; "they are groups of individuals bound together by some common purpose to achieve certain objectives," and include legislatures, firms, trade unions, churches, clubs, schools, etc. (Ibid.)

Cross-country regressions persistently demonstrate large and statistically significant correlations between institutional variables and growth in income per person (for a survey see Aron 2000). In horse races between variables, an index of institutional quality “trumps” geography or trade as an explanation for growth (Rodrik, et al. 2002).

This econometric evidence shows that institutions are important to growth, but it does so at a high level of aggregation that leaves unanswered the questions of which institutions matter and how to achieve them. A frustratingly large number of institutional variables are statistically significant. As Table 2 shows, growth in GDP per capita is significantly and positively correlated with protection of property rights and enforcement (seven studies); civil liberties (ten studies); political rights and democracy (ten studies); and institutions supporting cooperation, such as trust, religion, and the extent of social clubs and associations (four studies); and negatively with political instability (15 studies) (Aron 2000).

Table 2: Studies Showing Significant and Positive Correlations between Institutional Variables and Growth in Per Capita GDP

Significant Variables	Number of Studies
Protection of property rights and enforcement of contracts	7
Civil liberties	10
Political rights and democracy	10
Political instability	15
Institutions supporting cooperation (trust, religion, social clubs, etc.)	4

Source: Adapted from Aaron 2002.

Many of these institutional variables are aggregates of a number of specific institutions. Democracy, for example, depends on franchise rules, laws affecting voter access to information (such as those governing the media), constitutional divisions of power

between legislative, executive and judicial branches, norms that govern how people view corruption, law, or cooperation, etc.

Sorting out the role of specific institutions from this evidence is problematic. Some of the “institutional” variables in Table 2 are not institutions, but outcomes of institutions. Secure property rights is not an institutions but the result of laws governing contracting, copyright, and trespass, and of rules and norms about how these laws are enforced and obeyed. Proxies further confuse. Trade protection, black market premiums, and socio-economic conditions such as ethnic linguistic fragmentation, have all been defined as proxies for institutions. It is not clear why these variables are proxies for institutions rather than direct determinants of growth, nor can we be sure which specific institutions they proxy (Shirley 2005 forthcoming).

Even though institutional variables consistently explain a sizeable portion of economic growth, these studies fail to identify and test the specific casual institutions that lead to secure property rights, rule of law, or other characteristics of developed economies. They also fail to rule out the possibility that beneficial institutions are endogenous, a product of growth rather than its cause. Progress in our understanding must await better measures of specific institutions and further analysis of how institutions change.

#### *What Does New Institutional Economics Tell Us About Underdevelopment?*

Why have some countries evolved institutional frameworks that foster growth and social progress and others have not? In trying to answer this question, new institutional economics has explored a historical number of factors, most notably, colonialism, political competition or warfare, and beliefs or norms, as listed in Table Three. Since I

describe this literature in detail elsewhere (for a survey see Shirley 2005 forthcoming), I briefly summarize the arguments here.

Table 3: Why Do Some Countries Have Underdeveloped Institutions?

Explanations	Summary	Authors
Colonial Heritage	Colonies inherited poor institutions from colonial masters. Colonizers adapted institutions to enslave natives & exploit opportunities for plantation agriculture or mining. Boundaries of African states contributed to ethnic conflict & unaccountable governments.	(North 1990, 1994a) (Acemoglu, et al. 2001a, 2001b, Engerman and Sokoloff 2002)
Beliefs & Norms	Beliefs or norms inhospitable to trust & markets raised cost of building institutions to encourage impersonal trade & investment.	(Greif 1993, 1994, Knack 1997, North 1990, 1994b, 2004)

Source: (Shirley 2005 forthcoming).

*Colonization.* Most underdeveloped countries were once colonies, and many studies argue that weak institutions are a colonial legacy. But since countries such as Canada and Jamaica had the same colonial master but very different levels of economic development, some scholars argue that colonizers must have adapted their institutions to local conditions in ways that affected subsequent economic development. In South America and the Southern United States, for example, where colonialists encountered a large indigenous population that could be enslaved and/or a climate and soil suited to plantation agriculture, they developed institutions that exploited these opportunities, such as slavery. They also delayed introducing institutions that promote greater equality, such as rules that encourage immigration, expand the franchise, and extend access to secure and cheap schooling, banking and land (Engerman and Sokoloff 2002). In the Northern US or Canada, where the indigenous population resisted enslavement and the soil and climate were not suited for plantation agriculture, the opposite occurred. Colonists settled in greater numbers and developed institutions that fostered greater equality of income, skills and power, laying the foundations for industrialization and a consumer

market. This explanation works better for the Americas than for Africa, where neither differences in the colonial institutions nor differences in climate or agriculture can explain why African countries have similarly low levels of development.<sup>7</sup> Some scholars fault colonialism for failing to build state institutions and for drawing the boundaries of states in Africa in ways that made destructive ethnic conflicts more likely (Bates 2001, Herbst 2000).

*Beliefs and Norms.* Beliefs and norms also explain why some countries fail to prosper. Beliefs may hinder trust, which keeps people from transacting with strangers or relying on impersonal contracts and court enforcement of agreements (Knack 1997). Avner Greif shows how outmoded belief systems and norms of behavior can hinder progress, contrasting the individualistic cultural beliefs of the Christian Genoese and the collectivist cultural beliefs of the Jewish Maghribi traders (Greif 1994).<sup>8</sup> The Maghribis' collectivist beliefs were congruent with their horizontal social structure; Maghribi traders relied on partnerships, community ties, and "formal friendships" among cooperating traders to enforce bargains. Genoa's individualist beliefs underlay a vertical social structure; its merchants evolved bills of lading, written contracts, laws, and permanent courts to support bargains among traders who might be strangers from outside their social network. Ultimately, the Maghribis' failure to develop formal contracts, laws, and courts confined their trade to their network, where their collectivist enforcement was effective, while the Genoese grew rich through extensive and expanding trade protected by their

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<sup>7</sup> Acemoglu et al. argue that dangerous diseases curbed European settlement in Africa, which meant that colonists did not bring their superior institutions to Africa except to those safer colonies where more Europeans settled because the risk of diseases was less: Rhodesia, South Africa, Kenya. This does not explain the recent economic decline in these countries despite their presumably superior institutions and ignores the large European settlements in other places with dangerous diseases, such as the West Indies.

<sup>8</sup> He terms cultural beliefs the ideas and thoughts common to a group of individuals that "govern interaction between these people, and between them, their god and other groups" (1994, p.915).

impersonal institutions. Greif's analyses could explain why societies that were once wealthy such as China or Egypt become poor as circumstances change while belief systems and institutions lag behind.

### *How Do Institutions Change?*

This is a crucial question because, as North points out, we know which policies and institutions promote development, yet we don't know how countries can attain them. The institutional framework, the fundamental set of institutions that determine the environment for economic transactions, usually changes only incrementally. According to North, change is driven by competition, as institutional innovators see an opportunity to earn money, power, prestige and other rewards. Where status quo institutions compete with new rules of the game, the benefits of change are more apparent and dysfunctional institutions are more likely to be scrapped. The Western market economies arose in competitive, decentralized environments, the Netherlands and England, where many different economic experiments could be tried (North 2005, p.138). New ideas, such as the Enlightenment in the Middle Ages, and greater access to education and information can also be forces for change. But powerful individuals and organizations that benefit from the status quo will oppose institutional changes that might undermine their power and authority. These elites will try to control access to subversive knowledge and information and squelch dangerous ideas or innovators.

Even without this active opposition, institutional changes are only sustained when society's underlying belief system changes congruently, so that people incorporate the new institutional framework into their social norms. The acceptance of new rules as new norms of behavior transforms changes in laws into changes in practice. But as Greif's

story of the Maghribis illustrates, humans tend to resist changing their beliefs and habits, even when these beliefs and habits are economically costly.

Despite gaps in our understanding, new institutional economics does provide guidance about the nature of institutions and institutional change that can help us assess the role of foreign aid. Three conclusions are particularly relevant:

1. While many institutional changes occur at the margin, a society's fundamental institutional framework tends to be durable, lasting for centuries. Changes in less fundamental institutions are seldom successful if this broader institutional environment remains unchanged. For example, reformers may introduce a better commercial code, but its enforcement depends on laws governing legislative, bureaucratic and electoral choices; rules about the selection, motivation, and independence of judges; societal norms about corruption and commercial dealing; disclosure rules that make it possible to discover wrong-doing; and many other institutions.
2. Institutional frameworks endure because they are congruent with power structures and shared beliefs. Powerful people who believe they benefit from the institutional status quo that produced their power or wealth will actively oppose change. Even without active oppositions to reform, humans evolve habits and beliefs that make them resist revolutionary changes. Without changes in power structures and shared beliefs, institutional reforms will lead to large disparities between laws on the books and laws in practice.

3. Changes in institutional frameworks do occur and can be abrupt, revolutionary, and idiosyncratic, emerging from experimentation, competition, and adaptation to local conditions.

#### **4. Institutions and Aid**

##### *Characteristics of Country Institutions vs. Characteristics of Aid*

By contrasting the characteristics of institutions with the characteristics of aid and aid organizations we can see why aid may be a poor tool for reforming institutions.

1. **Institutional frameworks tend to be durable, but sustainable reform depends on changing them.**

The information, knowledge, and incentives of aid agencies are not focused on changing underlying institutional frameworks. Aid is aimed at changing policies, sector regulations, or organizations, not constitutions, norms of behavior, or electoral systems. This focus is inherent in the nature of aid (see 2 below) and has persisted even as donor rhetoric has changed.<sup>9</sup>

Even if aid were redirected toward changing institutional frameworks, its tools are poorly suited for longer term efforts. Aid projects tend to be relatively brief, less than three years, and project staff is rotated frequently, typically every three to five years.<sup>10</sup> Because of rotation, those supervising the execution of the project are seldom those who designed it and won approval. (As one World Bank colleague put it to me, you should “move before your mistakes catch up with you.”)

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<sup>9</sup> Although aid documents propose institution building, they often broadly define institutions to include rules or organizations that are more tractable to outside influence than more embedded formal rules and informal norms. For example, recent World Bank World Development Reports define institutions to include policies such as interest rates and organizations such as banks (World Bank 2002, 2003).

<sup>10</sup> World Bank staff are encouraged to move every three years; SIDA’s average staff time in one assignment is four years (Ostrom, et al. 2002, p.143)

Even without rotation, aid staff has few incentives to challenge fundamental rules and norms. Evaluating aid staff is difficult: because development is multifaceted and hard to measure, it is impossible to assign responsibility for economic outcomes to the actions of individual staff. Those aspects that are most easily monitored – project approval or disbursement -- are the ones most likely to influence careers (Martens, et al. 2002, p.20). Despite much rhetoric to the contrary, World Bank staff was rewarded for project approval, not for long-term project sustainability, throughout my tenure there; reports on other donors document the same focus on “moving the money.”<sup>11</sup>

**2. Institutional frameworks are supported by norms, beliefs systems, and powerful elites who benefit from the status quo.**

Aid agencies are not in the business of fomenting revolutions in politics or beliefs, and would soon be required to leave if they were. Donors work with the acceptance of governments in the recipient country and any project they finance requires a supportive or at least a permissive government. Political, religious, social, or other local leaders would oppose aid payments designed to alter constitutions, norms, or beliefs in ways that might undermine their authority and power. This is the case whether the leadership is what the UN Millennium project report calls “larcenous” or is what the report calls “well intentioned” (UN Millennium Project 2005). Leaders that don’t take this position don’t endure very long. Government and interest group leaders could conceivably be won over through persuasion, reassured through additions to their power in other spheres, bought off with side payments, or neutralized thorough publicity campaigns. But most aid

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<sup>11</sup> See Ostrom (2002). (See also Easterly 2002a, Martens, et al. 2002, .)

agencies resist playing such a direct role in financing change and fighting its opponents as outside their mandate or dangerous meddling in internal politics.<sup>12</sup>

Staff members have strong incentives to cooperate with incumbent governments.<sup>13</sup> A hostile government disrupts the project pipeline and leads to an inactive period that can adversely affect the staff member's budget, prestige, power, and prospects for promotion. Even when the aid agency's counterpart is a non-governmental agency or private enterprise, the government in the recipient country must at least tacitly permit the aid project to go forward. Donors lose leverage once a project is over, but staff rewarded for project approval has little incentive to hold new projects hostage to government's performance on its earlier commitments in aid projects that were probably designed by a predecessor.<sup>14</sup> Aid agencies tend to select as staff highly motivated, skilled, and altruistic individuals with a bias towards optimism and activism, individuals who may be reluctant to classify any government or problem as intractable.

### **3. Institutional changes can be abrupt, unpredictable, and idiosyncratic.**

Aid agencies are bureaucracies accountable to donor governments, and as such prefer to support Western best practice that can be more easily defended to their

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<sup>12</sup> The bylaws of the World Bank require it to be apolitical. Some bilateral agencies are required to support democracy in recipient countries, but they too avoid involvement in politics and require de jure evidence of elections rather than de facto proof of representation and accountability.

<sup>13</sup> This has an effect on reporting. World Bank reports that criticize an incumbent government are held in limbo or censored by project staff if they could adversely affect the project pipeline or influence an election. For example, a research report critical of the way Peru's Fujimori government had managed Lima's water system reform was held up by staff working in the country department because of the way the paper analyzed the government's political motivations, and attributed the failure to privatize to the president's desire to win votes. The paper was deemed a "liability" to the World Bank) since it would be seen as attacking the president before an election. The researchers were required to meet with one of Fujimori's advisors to discuss changes which would make the report acceptable to the government. Even after agreed changes were made the country staff allowed it to be released for publication only after Fujimori was ousted in 2000.

<sup>14</sup> This incentive problem can be tempered if a staff member has several clients or if the recalcitrant government is not particularly important to a donor's portfolio of projects, or heightened if responsibility for project approval is in field offices.

sponsoring governments than home grown reforms. They also prefer changes that can be instituted rapidly and be easily used as benchmarks for dispersing funds and assessing outcomes. This results in a focus on de juri rather than de facto change. De facto change is often slower, and is usually only measurable after the project is ended, if at all.

China's success in experimenting with institutional changes within a framework of Communist ideology, totalitarian rule, tenuous property rights, and weak rule of law illustrates the challenge to aid. China's federal system allowed provinces and local governments to compete by experimenting with different economic rules as long as the dominance of the Communist Party went unchallenged (Weingast 1995). Many townships and villages permitted private investors to run government-owned enterprises in exchange for regular payments to the local government that "owned" the firm. These so-called TVEs (township and village enterprises) allowed capitalistic incentives to flourish within an officially socialist system and contributed to China's surge in growth (Keefer and Shirley 2000). Despite their prominence, aid givers neither sanctioned nor supported TVEs. This is not surprising since aid agencies have no mandate to promote competitive experiments such as TVEs that rely on informal ties to the locality and, frequently, corruption, to secure their property rights.

### *Pro Forma Reforms*

When aid is provided in settings where an inhospitable institutional framework is left unchanged, the usual result is pro forma reforms. The situation is similar to that described by Buchanan as the Samaritan's Dilemma (Buchanan 1977). The payoff is highest to the Samaritan if the Samaritan provides aid and the beneficiary responds by exerting high effort. But the payoff is highest to the beneficiary if s/he receives aid

without increasing effort. The weaker a country's institutional framework, the greater the risk of Samaritan's Dilemma. As Ostrom notes, "When the recipient country is governed by officials who are primarily interested in seeking out opportunities for private gain, and few institutions are in place to keep these motivations in check, moral hazard problems can become substantial" (Ostrom, et al. 2002, p.11). Since incentives in aid agencies are directed at project approval rather than sustainability, aid staff is often complicit in accepting pro forma reforms rather than requiring extra effort in exchange for aid. The recent popularity of foreign aid projects directed at institutional reform may make these problems worse, because institutional projects lack tangible outputs, making impact "more diffuse and hard to verify" (Martens, et al. 2002, p.17).

An example of how pro forma reforms work in practice is the performance contract, which enjoyed a vogue among aid agencies in the 1980's. Performance contracts between a government and the managers of its state enterprises were championed by donors as a way to improve performance of state enterprises by setting specific targets and giving managers incentives to achieve them (Shirley and Xu 1998). Shirley and Xu (1998) found that in five of the six cases they studied governments signed performance contracts but failed to negotiate tough targets, demand the information needed to judge performance, pay promised bonuses for good performance, impose promised punishments for bad performance, or provide promised autonomy to lay off workers or close plants. Targets were weak and distorted. Although all the firms in the sample achieved their targets, there was no pattern of improvement in their trends in total factor productivity, labor productivity, or return on assets (Shirley and Xu 1998, World Bank 1995). Shirley and Xu's analysis of over 500 performance contracts in China also

found no statistically significant positive correlation between contracts and improvements in total factor productivity after controlling for selection bias and unrelated reforms (2001).

Performance contracts were widely supported in aid projects. Aid officials liked performance contracts because funds could be disbursed against a tangible action—signing the contract – and results gauged by a tangible outcome – achieving the targets. The signing of the contracts could be used as evidence of reform and as a concrete target for approval or disbursement. Aid staffers had few incentives to scrutinize the effects of contracts on subsequent enterprise performance, since they were rewarded for project approval and disbursements, not subsequent performance. High rates of staff rotation and constraints on staff time also made scrutiny of such apparently successful projects unlikely. Performance contracts also allowed projects to go ahead where privatization was politically unacceptable and past poor performance of state enterprises made further assistance impossible without some evidence of reform.

Recipient governments liked performance contracts because they could sign contracts and achieve their targets without politically costly actions. State enterprise managers could be forced to sign the contract and contract targets could be designed to be achieved without layoffs, plant closures, firing of incompetent managers, or other changes that might have nasty political repercussions.

#### *A Poor Track Record*

Under the circumstances, it should come as no surprise that aid has had little measurable success in improving institutions. Burnside and Dollar cite a number of studies suggesting aid has no beneficial effect on policies and institutions, concluding

that "...there is broad agreement that giving a large amount of financial aid to a country with poor economic institutions and policies is not likely to stimulate reform, and may in fact retard it" (Burnside and Dollar 2004, p.4).

Several authors go farther, arguing that aid has a negative effect on institutions, fostering rent seeking and corruption and tying up valuable resources in unproductive administration, effects which counteract any good outcomes from aid projects (Bauer 1991, Kanbur 2000, , cited in Harms, 2004). By reducing government's dependence on its citizens for tax revenue, aid makes the public sector less accountable and responsive to its citizens (Bates 2001, Herbst 2000). The large and cumbersome bureaucracies required to implement aid projects and meet aid reporting requirements have contributed to centralized administration and raised transaction costs (see Easterly 2002a).

Higher aid levels have been shown to erode the quality of governance, as measured by indexes of bureaucratic quality, corruption, and the rule of law (Knack 1997). The strong association of aid with a rise in rent seeking in less open economies and in those with large public sectors may account for the ambiguous effects of aid on growth (Economides, et al. 2004).

#### *A Challenge to this Conclusion: The UN Millennium Project*

The report of the UN Millennium Project argues that aid **can** promote institutional improvements in many poor countries. The UN Millennium Project lays out a strategy to implement the Millennium Development Goals, a set of laudable and ambitious goals developed at a UN meeting in Monterrey on DATE (The goals are shown in table four). The report of the Millennium Project notes that measures of institutions are correlated with income, and concludes that "...good governance helps achieve higher income, and

**Table Four. Millennium Development Goals**

<i>Goals</i>	<i>Targets</i>
1. Eradicate extreme poverty & hunger	<ul style="list-style-type: none"> <li>• Halve % people whose Y = &lt;\$1/day between 1990 -2015</li> <li>• Halve people hungry, 1990 to 2015</li> </ul>
2. Achieve universal primary education	<ul style="list-style-type: none"> <li>• By 2015</li> </ul>
3. Promote gender equality & empower women	<ul style="list-style-type: none"> <li>• Eliminate gender disparity in primary &amp; secondary ed. by 2005 &amp; in all education by 2015</li> </ul>
4. Reduce child mortality	<ul style="list-style-type: none"> <li>• Reduce 1990 under-5 mortality rate by 2/3rds by 2015</li> </ul>
5. Improve maternal health	<ul style="list-style-type: none"> <li>• Reduce 1990 maternal mortality rate by 3/4ths by 2015</li> </ul>
6. Combat HIV/AIDS, malaria, & other diseases	<ul style="list-style-type: none"> <li>• Halt &amp; begin to reverse spread of HIV/AIDS by 2015</li> <li>• Halt &amp; begin to reverse incidence of malaria &amp; other major diseases by 2015</li> </ul>
7. Ensure Environmental sustainability	<ul style="list-style-type: none"> <li>• Integrate principles of sustainable development into country policies &amp; programs &amp; reverse loss of environmental resources</li> <li>• Halve % people w/o sustainable access to safe drinking water &amp; basic sanitation by 2015</li> <li>• Significantly improve lives of at least 100 million slum dwellers by 2020</li> </ul>
8. Develop global partnership for development	<ul style="list-style-type: none"> <li>• Develop open, rule-based, predictable, nondiscriminatory trading &amp; financial system</li> <li>• Address special needs of Least Developed Countries</li> <li>• Address special needs of landlocked &amp; small island developing countries</li> <li>• Deal comprehensively with debt problems of developing countries thr national &amp; internt'l measures to make debt sustainable in long term</li> <li>• Develop &amp; implement strategies for decent &amp; productive work for youth in cooperation w/ developing countries</li> <li>• Provide access to affordable essential drugs in developing countries in cooperation w/ pharmaceutical companies</li> <li>• Make available benefits of new technologies, esp info &amp; communication, in cooperation w/ private sector</li> </ul>

Source: Adapted from: [www.un.org/millenniumgoals](http://www.un.org/millenniumgoals).

higher income supports better governance.” (UN Millennium Project 2005, p.110). It argues that governance, i.e. the functioning of the polity, can be improved by investing in factors such as education and health that support economic growth and human capital accumulation. (p.112).

The report further argues that there are two kinds of poor countries, the few with “truly rapacious government leadership” that lack the “volition” for improving governance (p. 113) and the many with “well intentioned” governments that lack the resources for improving governance. The report calls for rich countries to provide more money to support public administration, strengthen the rule of law, increase transparency and accountability, promote political and social rights, promote sound economic policies, and support civil society in “well intentioned” group (p. 114). Simultaneously, donors are to support investments to achieve the other Millennium goals and lift the country out of its “poverty trap.” (p. 32).

Economic development may indeed produce or reinforce good institutions, but there is no evidence that money can buy good institutions. There are rich societies with poor institutions, such as the southern US before the civil war and many oil exporting countries today.<sup>15</sup> Nor is there evidence that good institutions can be installed by using aid transfers to invest in governance. Past efforts to do just that have failed, as we have seen. The report attributes the failure of aid to secure development or improve

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<sup>15</sup> Sachs and Warner argue that windfalls from valuable natural resources like oil corrupt a country’s governance and promote under-investment in other productive sectors (Sachs and Warner 2011). Money from natural resources is seen as qualitatively different from money from aid, perhaps because the aid money is intended to be part of a broader program of development. Yet large inflows of aid have many of the same effects – encouraging rent seeking and diverting investment. The resource curse argument ignores successful, resource-rich countries such as the US, Australia, or Norway. The US, for example, dominated world petroleum production from the late 1800’s until 1960 (Wright and Czelusta 2003, p.13). Wright and Czelusta argue that abundant natural resource wealth does not undermine societies with strong institutions.

governance to aid donors' piecemeal and incoherent approach, as well as donors' focus on the short run, lack of coordination, inadequate technical support, and shortfall in funds (Chapter 3). While some of this criticism of aid is merited, many of the failings are inherent in the nature of aid agencies.

New institutional economics finds that societies inherit beliefs and institutions that give powerful individuals and organizations a vested interest in preserving the existing institutional structure. This is not a matter of rapacious versus well-intentioned governments or rich or poor countries, but a product of human history. The proposition that aid givers armed with better advice and more money can overturn such a heritage ignores the hard earned lessons of development assistance. Past failures of aid were not for want of funds or lack of comprehensive strategies to promote reforms across the board. Aid over the past five decades amounting to about \$2.3 trillion in today's dollars and failed to produce growth -- or good institutions. Ambitious aid programs that tried to cure many ills simultaneously were tried and abandoned as costly debacles. World Bank efforts to improve public administration, strengthen rule of law, or otherwise develop institutions have been judged "largely ineffective" by its Operations Evaluation Department (Girishankar 2001, p.1).

### **5. Can Aid Avoid Institutions?**

If aid givers cannot improve damaging institutions, can they avoid their ill effects? Aid givers have tried to protect their projects from poor institutional environments by: (i) creating project implementation units insulated from the problems of the recipient country's government, (ii) bypassing governments to work directly with NGOs or using groups of beneficiaries to dilute government influence, and (iii)

identifying and supporting only those countries that are improving their institutions and so can presumably use aid more effectively.

*(i) Project Implementation Units*

Many aid agencies have tried to insulate project management by creating dedicated local project implementation units (PIUs) staffed by the country's most highly skilled civil servants or consultants with salaries topped up by aid funds to many multiples of official salaries. Although nominally part of the recipient country's government, they are highly responsive to the donor agency. Studies of the World Bank's experience in hundreds of projects in South America and Eastern Europe and Central Asia have shown that these project implementation units "...have no significant positive impact on project outcomes, while the likely sustainability of results clearly suffered" (World Bank 2004, pp.205-06).

*(ii) NGOs or Beneficiary Groups*

Non-governmental organizations (NGO's) have been suggested as a way to bypass corrupt, disinterested, or repressive governments (Martens, et al. 2002). Greater participation in the design and implementation of aid projects of the most affected beneficiaries could be a way to pressure a government that is reluctant to reform. As Pritchett and Woolcock point out (2004), there is considerable disagreement about whether these solutions do work under all or even most conditions and for all or even most projects.

Reliance on beneficiary groups or NGO's has its perils. By-passing government could undermine societies' efforts to build representative and responsible political institutions. Un-elected NGOs that control large amounts of aid funds can become

powerful alternative power structures. Groups and leaders selected to participate in project decisions are similarly empowered, and may not represent or be accountable to all beneficiaries. Donors often have little information about local NGOs or interest groups, and local standards of transparency and accountability are usually poor in weak institutional settings.

More fundamentally, participant groups and NGOs cannot consistently circumvent a society's deep institutional ills. Under the right circumstances these approaches have improved the success of individual aid projects and the lives of their direct beneficiaries (See cites in Prichett and Woolcock 2004). But to the extent that success depends on bypassing a country's dysfunctional government and damaging institutions it is unlikely to be sustained. Weak systems of accountability, patronage based reward systems, high transaction costs, lack of property rights, conflict and violence, can all threaten or corrupt even the most dedicated organizations. There are noteworthy exceptions, but generalizing from these exceptions is risky since, as Prichett and Woolcock point out, successes grow out of local conditions that may not exist in other institutional or political circumstances.

*(iii) Selectivity*

If foreign aid cannot change a country's fundamental institutional infrastructure, perhaps it can promote development by focusing only on those poor countries that already have better or improving institutions. There is some, still inconclusive, evidence that aid is effective in countries that already have better institutions. Burnside and Dollar showed statistically that aid promotes growth in better policy and institutional environments (Burnside and Dollar 2000, 2004), but there are a number of challenges to

these findings.<sup>16</sup> Easterly et al. reproduce Burnside and Dollar's methodology, but when they add additional countries and years the positive growth effect of aid in good policy environments loses its statistical significance (Easterly 2003). Burnside and Dollar's results are also fragile to changes in the specification of the policy and institutional variables (Brumm 2003, Easterly, et al. 2003, Harms and Lutz 2003). Roodman finds the result is weak in empirical tests (Roodman 2004).

Others argue that aid has a positive but non-linear effect, perhaps because of decreasing returns to aid (see studies cited in Harms and Lutz 2004). Kosack argues that aid contributes to improvements in a quality of life index that averages life expectancy, the combination of literacy and school enrolment and the log of per capita GDP in more democratic developing countries and to deteriorations in quality of life in more autocratic countries (Kosack 2003). Kosack finds that aid's effects become positive at some threshold level of democracy and somewhat offset the tendency of more democratic poor countries to have lower growth in quality of life (Ibid.)

Historical evidence also shows that aid can successfully assist countries that already have stronger institutions; consider the Marshall Plan in Europe and the development of backward members of the European Union. The transition in Eastern Europe has been credited in part to political consensus on the need to establish the foundations of market economies combined with foreign assistance and advisors working closely with local institutional entrepreneurs (Murrell 2005, forthcoming).

Dollar and Levin argue that aid is already more selective at least in comparison to the indiscriminate policies of donors in the past. Between 1999 and 2002 they find a positive association between aid and the Country Policy and Institutional Assessment

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<sup>16</sup> For a survey see Harms, 2004.

(CPIA), an index based on the views of World Bank staff (Dollar and Levin 2004). They also find a positive although much smaller relationship if they use indices based on expert rankings of countries' rule of law or measures of civil and political liberties (Ibid.). But neither the CPIA nor the expert rankings tell us which countries are capable of using aid productively.

Better institutions are more likely to be found in middle- and higher-income countries, countries which have the least need for foreign assistance. Selectivity demands a focus on the poorest countries, those that need aid the most yet still have sufficiently developed institutions to use it effectively. Given the current state of our knowledge, it is often difficult or impossible to judge which countries are on this margin.

The US government's millennium challenge account (MCA) illustrates the difficulties of determining whether countries are reforming their institutions enough to use aid productively. The MCA was created in 2002 to disburse funds only to those countries that meet its criteria for controlling corruption, "governing justly", "investing in people", and "promoting economic reform". (See Table Five for the criteria.) To qualify for assistance countries must score in the top half of all potentially eligible countries on the control of corruption criteria and on half or more of the other criteria under each of its three performance dimensions.

**Table Five: Millennium Challenge Account Performance Criteria**

<b>Performance Dimension</b>	<b>Performance Criteria</b>
<b>Governing Justly</b>	Civil liberties Political rights Voice and vote Government effectiveness Rule of law Control of corruption
<b>Investing in People</b>	Immunization rates (diphtheria & measles) Public expenditures on health Primary education completion rate Public expenditures on primary education
<b>Promoting Economic Reform</b>	Country credit rating Inflation rate Days to start a business Trade policy Regulatory quality Fiscal policy

Source: MCA Data on the Web at [www.MCA.gov](http://www.MCA.gov).

These criteria have serious measurement problems described by Kauffmann et al. (2002). The margins of error are so large for the estimated corruption measure, for example, that it is impossible to say with 90% certainty whether 51 of the 61 countries rank in the top half or the bottom half of the sample (Kauffmann and Kraay 2002, , Figure 1). Errors are not the only problem. Some of the criteria may not be good measures of performance. For example, as we have seen, spending on education is meaningless in countries where institutional failings create low returns to schooling. Important measures are excluded according to Boettke, Aligica, and Hooks, notably entrepreneurship, property rights and political capacity (2004). Some measures reflect legal formalities rather than actual practice: the days-to-start-a-business criterion, for instance, is based on judgments of lawyers about a non-representative, hypothetical firm

and differ substantially from surveys of local businesses (World Bank various).<sup>17</sup> To measure progress the MCA should use the change in criteria rather than the static rank, yet many of these criteria change very slowly or not at all. This may be because countries are not reforming or it may be because of the crude nature of the measures.

Besides these measurement problems, the MCA (and the World Bank's CPIA) suffer from a more fundamental flaw: given the current state of knowledge, there is no way to know whether these are the correct criteria to gauge whether a country is creating the institutional framework necessary for successful aid projects. Some of the governance indices used in the MCA are highly significant in cross country growth regressions, but as I discussed earlier, they are aggregates of many specific institutions and could be endogenous – the outcomes of development rather than the causes. Even if the criteria are correct, there is no way to know what threshold a country must attain to create an aid-supportive environment. The MCA assumes that a country that does better than half the poor countries on half its criteria will use aid well, but there is no empirical basis for this assumption. It seems more likely that aid will only make an effective contribution to development above some unknown but potentially measurable threshold level of institutional quality.

Some critical factors are not being measured at all. There is statistical evidence that the quality of aid depends on selectivity on the demand side more than on the supply side. Wane shows that the most important factor determining the quality of World Bank

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<sup>17</sup> The measure used by the MDA is based on the World Bank's estimates in *The Cost of Doing Business* (various) which uses a hypothetical firm with 50 or more workers and 5 shareholders, located in the largest city in the country, and with a start up capital at least ten times the per capita income in the country. It further assumes that all the steps are done by the entrepreneur and no bribes are paid. This hypothetical firm represents a very small sample of firms in most developing countries: in Peru 98% of businesses have less than 20 employees, most have far less start up capital or partners, and surveys show that almost all entrepreneurs hire a facilitator (Jaramillo Baanante 2004). The number of days reported by the World Bank is 45% higher than that reported by a sample of small garment manufacturers in surveys.

projects was quality of design (based on internal evaluations of project and design quality), and quality of design was endogenous to the borrower's capacity to select better projects and reject worse ones (Wane 2004). In Wane's regressions the usual governance indicators used by Burnside and Dollar or the MCA do not predict project performance once quality of design is taken into account. He concludes that in countries where the government has the "capacity to screen and select projects conducive to development," and where they are "held accountable enough to their citizens to be deterred from accepting bad aid projects," design quality and hence impact of aid will be higher (Wane 2004, p.1). Wang's findings are supported by the experience of successful developers such as Chile and China (see below). This means that the institutions that determine the quality of aid are likely to include the recipient's civil service rules and norms that attract and motivate competent and honest civil servants, political institutions that reward selection of better projects, information systems that keep politicians and the public informed about what civil servants are doing and keep the public informed about what politicians are doing, electoral systems that allow voters to hold politicians accountable, educational structures and norms that produce a pool of talent to staff the government and the opposition, and networks providing scholars with research opportunities, incentives, feedback, collaborators, critics, funding, and access to media and policy makers.

## **6. What Can Be Done?**

New institutional economics is not good news for foreign aid. Although most donor agencies have embraced the idea that institutions matter, they have not considered the implications of this message for their business. If, as I have argued, damaging institutional frameworks must improve for development to occur, then NIE strikes at the

heart of the aid mission. Foreign aid has financed a great many successful projects that have assisted many poor people, and it has fostered important reforms in some damaging rules. But aid has not led to development and it has not changed fundamental institutions. Aid sponsored improvements in rules and regulations can be undermined by disequilibria in more fundamental institutions. By providing funds and credibility, foreign assistance has probably prolonged the life of some corrupt and incompetent governments and reduced the pressures for reforms.

A fundamental premise of foreign aid is that people and societies will select best practice policies and institutions if they can be shown that they will be better off and if there are funds to help defray the costs of change. The UN Millennium Project is an example of this reasoning. Unfortunately human history does not support this premise. North (2004) shows how throughout history damaging institutions have endured because change was opposed by powerful people who believed they benefited from the status quo, resisted by less powerful people unwilling to change their beliefs and habits, and thwarted by the inertia of fundamental institutions. Opportunities for changing fundamental institutions do arise in underdeveloped economies, but not because of aid. Aid givers would exceed their mandate and their welcome if they tried to engineer opportunities for change in deeply rooted rules and norms. Nor can they control the direction of change and assure that the outcome is for the better. Beneficial change is often idiosyncratic and contrary to best practice and received wisdom of donors. Aid could perhaps be effective if it was directed only to countries that are creating the institutional prerequisites and political circumstances to use aid effectively, but this is often impossible to judge given our current state of knowledge.

What can be done under these circumstances? Some have suggested that aid support experiments and rely more on markets for aid distribution. And there is clearly a pressing need for more research and better specific information on institutional development. Since successful reform requires local knowledge and experimentation, it is crucial to improve local capacity to analyze their own institutions and make informed choices. I consider each of these below.

### *Experiments and Markets*

Prichett and Woolcock argue that aid agencies should abandon the search for a single approach, *the* solution, and “...try to foster genuine experiments to discern the most appropriate local solutions to local problems that can be nurtured and sustained, while also seeing them as a necessary part of a broader and more holistic country development strategy.” (Prichett and Woolcock 2004, p.207). This sensible advice would be very hard for aid agencies to follow given their incentives to pursue best practice and placate recipient governments. It would require a radical redesign of aid procedures.

Several authors have proposed more market driven approaches to aid (Easterly 2002a, Hahn and Tetlock 2004). Easterly proposes a central fund that only good governments could access, something like the MCA, as well as giving vouchers to beneficiaries so they could decide which aid agency to get their funds from. This confronts the same measurement problems mentioned earlier, but if these can be solved it could be a way to overcome the selectivity problem and the Samaritan’s Dilemma simultaneously.

Hahn and Tetlock suggest pay-for-performance — auctioning off funds to the lowest bidder. For instance, so much aid would be disbursed for each child vaccinated or

schooled with outside auditors checking on results. This approach would only work for aid projects where outcomes are short term and can be clearly specified and objectively measured, which is a small – although important -- subset of aid projects today. Hahn and Tetlock also propose using information markets to determine what the highest priority tasks are and what the likely returns will be from aid projects.

These creative approaches are certainly worthy of some experiments. It may be that a market driven approach to aid would not only improve project success but also encourage some countries to reform their institutions in order to be able to access the aid funds. And even if deep institutional changes don't result, market driven aid would have a lower risk of propping up venal governments and delaying institutional reforms.

#### *Information and Data*

As we have seen, most measures of institutions operate at high levels of abstraction. We are beginning to understand some of the factors that seem to be important everywhere, but more research is needed to be able to judge whether a specific country is improving the specific institutions essential to its productive employment of aid and progress towards a market economy. These critical institutions are often political, yet few donors have been ready to move beyond generalities or platitudes about democracy to study the inner workings of political markets or document what political circumstances allow reforms to occur in individual cases. The World Bank is an exception but it too has only a limited program of research on political economy and its board and operations staff is sensitive to political analyses that move beyond cross-country regressions to country cases that might embarrass large borrowers.<sup>18</sup>

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<sup>18</sup>*Bureaucrats in Business* (World Bank 1995), a policy research report that deals explicitly with political motivations, parties, and corruption, was nearly banned from publication by the World Bank's Board of

Far more work is needed to measure institutional progress accurately. If specific reforms are to succeed in specific circumstances, then broad indices and relative rankings will need to be replaced by in-depth understanding of the institutional prerequisites required in specific settings. Local knowledge is critical to understanding a country's institutions, particularly informal institutions such as norms of behavior. This argues for building up local databases and research capability, and continuing to develop and improve detailed measures of performance, such as the Ronald Coase Institute's measures of the cost of exchange (RCI-COE). The RCI-COE systematically calculates the full opportunity costs (in terms of money, time, and goods) that individuals incur to achieve a good or service, for example, to obtain a telephone, receive title to a piece of land, or register a new business legally (Benham and Benham 2001, see also Jaramillo Baanante 2004). The RCI-COE gives concerned citizens accurate, precise, and timely information concerning which costs of doing business are high – and how high—so they can work to reduce these costs. Using the RCI-COE, citizens can measure the costs of exchange accurately, try institutional reforms to reduce high costs, and then measure to see whether reforms were successful or not. The RCI-COE also allows users to compare costs across countries, over time and between different groups in the society such as women or minorities. It provides a quantifiable measure of the effectiveness of aid sponsored reforms.

More international research is needed on the dynamics of institutional change and on the specific institutional and political prerequisites required to implement high priority

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Directors for its discussion of politics (author was present at the discussion and leader of the team that produced the report) . While there has been greater openness towards political discussions in Bank documents since then, there is still considerable opposition to cases studies of contemporary political markets in the World Bank.

policy reforms. Much effort has been expended on setting global priorities and objectives (the Copenhagen Consensus, the UN Millennium Development Goals), but there is far less work on how high priority policy and institutional changes are actually implemented. The need for improvements in governance or in institutional frameworks is often mentioned in aid reports, but usually in the vaguest of terms. There are few case studies of reform success and failure that combine the rich detail necessary to understand institutions and political circumstances with careful and quantifiable measures of change. Especially rare are comparative case studies that would allow subsequent meta-analysis and provide a much sounder estimate of how implementation of sustainable policy improvements actually occurs, and much better measures of when countries have the will and capacity to change. Until this analytical base is built, aid will continue to be targeted and evaluated on the basis of vague measures that reflect donor optimism and data availability rather than economic reality.

### *Building Capacity*

Ultimately fundamental institutional reforms depend on the decisions of a country's citizens and the individuals who govern them. Some have argued that aid should push countries to become democratic, so that citizens can decide which institutions serve them best. But this ignores the fact that representative democracy itself rests on a complex of rules and norms, such as electoral rules and procedures that are designed and perceived to be fair, trust that the elected will not destroy their opponents and will cede power should they lose future elections, rules and norms to check arbitrary government discretion and enforce accountability, and guarantees of freedom of the press and access of competitive groups to information and communication. If aid has been

ineffective at changing economic institutions, it is hard to see how aid could be more successful at changing political institutions. Efforts to restrict aid to democracies or democratizing countries run into the same measurement and agency problems I described above.

Enduring economic reform happens when people better understand the world they live in and devise their own ways to build institutions and markets. Recent development successes are countries that built the intellectual capital needed to analyze their problems and exploit reform opportunities when they arose – Chile, China, Korea, Taiwan. Chile, a country with strong institutions, is an example of how exceptionally well-trained government officials can contribute to economic decision making and control the design of aid projects, while exceptionally well-trained opponents can force improvements and compete for control. Under the Pinochet dictatorship Chile had an economic team known as the Chicago Boys because of their training in economics at the University of Chicago, who were highly skilled, while the opposition had equally well trained thinkers. Although the Chilean government under Pinochet was not accountable to the citizenry in any democratic sense, its technocrats were sensitive to the barrage of criticism and critiques from their peers outside the government, at least on some fronts. For example, a purchase of subway cars without the legal mandated cost: benefit analysis was halted because of editorials authored by a prominent university professor.<sup>19</sup> The design of pricing regulation for utilities was altered in response to articles by opposition scholars.<sup>20</sup> The dictatorship was not wholly indifferent to public opinion, as evidenced by the fact that it held two plebiscites, one on the constitution, which it won, and the other on the

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<sup>19</sup> Conversations with Ernesto Fontaine, the professor in question.

<sup>20</sup> Conversation with former Pinochet government officials responsible for water and electricity regulation.

continuation of the regime, which it lost. After losing the second plebiscite, it held elections and peacefully turned power over to its opponents when they won. The opposition had been studying the success and failures of the regime and other Latin American countries making the transition to democracy, and they put this knowledge to work in designing policies under democracy (Marshall 2004). Scholarship, research, and informed public debate have been instrumental in the design of Chile's economic and institutional reforms. Foreign aid supported this effort, but on Chilean terms; Chile routinely rejected donor-driven aid projects that it considered unnecessary or ill advised.<sup>21</sup>

Although not studied fully, China's emphasis on building its intellectual capital may be playing an equally important role in institutional reforms. Large numbers of Chinese were educated in universities and returned to China to staff the universities and the bureaucracy. Since Deng Xiaoping's adoption of a "strategy of strengthening China through human capital" in 1978 a total of 700,200 Chinese nationals have studied abroad, and by the end of 2003 some 172,800 of them had returned (Li 2004, p.2). They make up the majority of professors at Chinese universities and fill such top positions as Vice Minister of Commerce, Chairman of the China Banking Regulatory Commission, Vice President of the Supreme Court, and Mayor of Shenzhen (Ibid.). Since 1988 China has also had a policy of establishing world-class universities. This was combined with intentional policies to increase turnover in mid-level and top positions in the provincial governments, including age limits on some positions (Li 2002). Like Chile, China's technocrats have largely controlled the design of aid projects.

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<sup>21</sup> Conversations with Chilean officials during this period; at the time I was the World Bank economist for Chile.

Intellectual capital of the kind built in Chile and China has not been a central focus of donors. Aid givers have emphasized primary education and have trained policy makers and bureaucrats, but intellectual leaders have received less attention, except as potential staff or consultants. Increasing the skills of bureaucrats and policy makers through aid sponsored training can be beneficial, but only if the current systems of incentives reward them for innovation or greater productivity. The individuals who will challenge a society's damaging institutions and beliefs are more likely to come from outside the bureaucratic or political system.

There have been some large scale donor efforts to build intellectual capacity through support to universities or research institutions, such as the Global Development Network, can be undermined by the same institutional flaws that defeat other forms of development assistance. In damaging institutional settings, universities and research institutes divert research funds into overhead or inappropriate uses. Pay and perks are often monopolized by the heads of departments and research institutes, while research is done by poorly paid and motivated junior scholars. Aid recipients follow the wishes of donors by selecting politically correct or fashionable topics. A great deal of funding goes into bureaucratic oversight structures designed to assure a balance of nationalities, gender, and intellectual pursuits. In my experience donors are not equipped to select and support individuals doing self-motivated research. To the contrary, by offering large support for topics favored by donors, aid sponsored research may undermine the sort of intellectual curiosity that leads researchers to put time and effort into investigating important problems despite little immediate personal rewards.

Well trained and highly motivated local scholars can become the advisors, bureaucrats, teachers, and opinion leaders with the local knowledge to design and implement sustainable reforms. They can bridge the gap between outside advice about global best practice and the demands of local circumstances and interest groups. Such scholars may need funding, but it takes more than money to give young scholars the wherewithal to remain in their country and have an impact. They need networks, mentoring, collaborators, outlets to publish and disseminate their work, and certification of the quality of their research against world standards by objective outsiders. This requires scholar-by-scholar support and hands-on training and mentoring linked to the best first-world researchers, such as the support provided by the Ronald Coase Institute.<sup>22</sup> Intellectual capacity alone is not enough to forge meaningful reforms; a political opening for change will also be needed. But without intellectual capacity there will be little chance of sustained improvement.

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<sup>22</sup> See [www.coase.org](http://www.coase.org).

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