Aid and Poverty Reduction: Whose Well-being and How to Increase It

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Abstract

Aid in its various facets is central to the implementation of development policy. Traditionally, aid effectiveness has been evaluated against impacts on economic performance but recently the emphasis has shifted towards achieving an impact on poverty reduction: 'enhancing the well-being of the poor' can now be acknowledged as an objective of aid. We characterize two approaches to directing aid towards poverty reduction. The first focuses on the allocation of aid across recipients and is inherently somewhat mechanistic: arguing that donors are unable to effectively target aid on poor households and that growth is the only sustainable way to reduce poverty, proponents of this approach advocate reallocating aid to those recipients where the potential to reduce poverty via growth is greatest. We argue that this approach represents the prevailing discourse on aid and poverty reduction. The second approach focuses on how aid is used, in particular what activities are financed by aid, and is more instrumental: proponents argue that aid used to increase the provision of public goods offers the greatest potential to improve the well-being of the poor (and in doing so can contribute to growth objectives). After reviewing the conceptual foundations and evidence associated with each approach, the paper derives implications for aid policy and concludes by considering whose well-being is actually served through aid in each approach.

Keywords: Aid and Poverty Reduction, Aid Allocation, Public Goods and Welfare

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1 INTRODUCTION

Aid in its various facets is central to the implementation of development policy. Traditionally, aid effectiveness has been evaluated against impacts on economic performance and in particular on economic growth. In this growing and contentious literature the typical approach is to test if the coefficient on aid is significant and positive in a cross-country growth regression. Morrissey (2006) characterizes the current sate of the debate as being between those who view the glass as half full and those who view it as half empty. The pessimists (half empty) contend that aid is generally not effective in contributing to growth, although countries with good economic policies are able to utilise aid effectively. The optimists (half full) counter that aid is in general effective, independent of policy, but the impact on growth is quite small (i.e. the coefficient on aid is positive and significant but small). Recently donors and researchers have placed more emphasis on the impact of aid on poverty reduction: 'enhancing the well-being of the poor' can now be acknowledged as an objective of aid. This has prompted work on aid effectiveness in terms of poverty reduction that can also be characterized as falling into two camps, typically reflecting the dichotomy of views on aid effectiveness in terms of growth.

Poverty and poverty reduction can be defined and interpreted in many different ways. A full discussion of this is beyond the scope of this paper and we limit attention to two approaches prevalent in the economics literature on aid. One approach is to focus on aggregate country measures of income poverty, typically the headcount ratio (the proportion of the population below some income poverty line) or simply the headcount (the number of poor). In this context reducing poverty means reducing the headcount which means increasing incomes (of some of the poor). As there is a strong correlation between economic growth (rising incomes) and poverty reduction (falling headcount), achieving growth is typically advocated as the core strategy to reduce income poverty. An alternative approach focuses, at least conceptually, on a broader definition of poverty accounting for non-income aspects such as health status and access to health services, education and clean water for example; in economics language, a common term used would be the welfare of the poor (which includes income, but also includes access to non-pecuniary goods and services that provide utility or benefit).

Associated with the dichotomies outlined above (aid pessimists who tend also to adopt income poverty and aid optimists more prone to think in welfare terms) we characterize two approaches to directing aid towards poverty reduction. The first focuses on the allocation of aid across recipients and is implemented in a somewhat mechanistic manner: the objective is to allocate a given budget across potential recipients so as to maximize the reduction in the number of poor, and the mechanism is each country's (income) poverty response to aid, combining the effect of aid on growth and of growth on poverty reduction. Given the assumptions that donors are unable to effectively target aid on poor households and that growth is the only sustainable way to reduce poverty, proponents of this approach advocate reallocating aid to those recipients where the potential of aid to increase growth is greatest (the impact of growth on poverty reduction is typically assumed to be the same across countries). The second approach focuses on how aid is used, in particular aid-financed government spending. This approach is more instrumental: aid can be used to finance particular projects, interventions or types of government spending, some of which are more likely to benefit (increase the welfare of) the poor than others. Proponents argue that aid used to increase the provision of public goods offers the greatest potential to improve the welfare of the poor (and in doing so can contribute to growth objectives).

The first approach is closely associated with the World Bank, and as such can be said to encapsulate a discourse on aid and poverty reduction. The discourse revolves around policy and growth, or more specifically growth-promoting policies. Contributions in this literature create a discourse by explicitly repeating, or implicitly accepting, a number of propositions (that often appear as mantras): aid is only effective in countries with good policies, good policies are those that promote growth, good policies require good governance and growth is a prerequisite for poverty reduction. Often it is not the aid itself that is important, but the policies supported and promoted by donors; Poverty Reduction Strategy Papers (PRSPs) are perhaps a dominant current example of this discourse. The second approach, perhaps because it is not championed by a specific organisation, lacks the coherence and focus of a discourse although contributions share common themes. Prominence is given to the provision of public goods and access to services as means of increasing welfare; policy and growth exist in the background and aid is important because it finances government spending or delivers public goods directly.

The remainder of the paper begins, in section 2, with a discussion of the aid allocation approach, summarising the building blocks of the argument from policy to growth to aid reallocation. Section 3 considers the alternative based on public goods, reviewing evidence on the effect of aid on the level of social spending and the impact of aid delivered through public social spending on welfare. Section 4 then presents our argument that the first approach amounts to a World Bank discourse; although we do not claim this, it could be argued to represent the current manifestation of the Washington Consensus (applied to poverty reduction). The conclusions and policy implications are in section 5, which also considers whose well-being is best served by aid under each approach.

2 AID ALLOCATION FOR POVERTY REDUCTION

The aid allocation approach takes as a starting point what we described above as the ‘aid pessimists’ view of aid effectiveness. This ‘aid doesn’t work’ view, represented in World Bank (1998), rests on a four step argument (Morrissey, 2006). First, the amount of aid alone has no effect on growth, i.e. the coefficient on aid in a cross-country growth regression is insignificant (Burnside and Dollar, 2000). Second, a term for aid interacted with a policy indicator is positive and significant, i.e. aid makes a positive contribution to growth only in those countries with good policy – ‘aid only works in a good policy environment’ (World Bank, 1998; Burnside and Dollar, 2000). Third, attaching policy reform conditionality to aid does not work, i.e. donor/aid leverage does not ensure that governments implement good policies (World Bank, 1998; Svensson, 2000a). Donors ‘are unable to exert significant net influence on policies and institutions, and are unable to by-pass the government in implementing expenditures’ (Collier and Dollar, 2004: F245). A related concern here is that aid reduces the pressure on government to impose economic discipline, especially regarding fiscal policy, and so encourages rent-seeking and corruption (Svensson, 2000b) and supports governments with ‘bad’ policies (Svensson, 1999). Fourth and as a consequence, (increased) aid should be given to those recipients already implementing good policies (Dollar and Levin, 2004). This has been extended to aid effectiveness in reducing poverty in Collier and Dollar (1999, 2001, 2002, 2004).

As extended to the allocation of donor aid to maximise the impact on growth and poverty reduction, the implicit assumption is that aid only works in the sense of contributing to growth (and in this way to poverty reduction) when government policies are ‘good’ (a concept that is rarely explicitly defined). Expositions of this view appear plausible: ‘the interaction of aid and policy is good for growth, so that aid enhances the growth effect of policy and good policy increases the growth effect of aid’ (Collier and Dollar, 2001: 1787-8). This is an example of the discourse: the importance of policy is presented as fact and the evidence in papers is something of a citation club (all contributors supporting the discourse are in or associated with the World Bank, the originator of the discourse). To unravel the argument one has to go outside this citation club. The alternative view that aid effectiveness is not conditional on policy (Hansen and Tarp, 2001; Dalgaard *et al*, 2004), hence that the case for selective aid reallocation is not proven, is typically ignored or acknowledged only to be criticised and rejected.

The Collier and Dollar (especially 2002, hereafter CD) poverty efficient aid allocation model explicitly assumes that aid only works in a good policy environment and estimates the allocation of aid across about 100 countries that would maximize the number of people lifted out of poverty. This optimisation is based on estimates of country parameters for the impact of growth on poverty reduction using the $2/day poverty line headcount rate and a simplifying assumption that the elasticity of poverty with respect to income is a constant 2 for all countries. The emphasis is on growth because it is not possible to target individual (poor) households so donors ‘can only affect poverty by raising aggregate income’ (Collier and Dollar, 2002: 1483). Other avenues for reducing poverty are precluded given donors assumed inability to target the poor or affect income distribution.

A comparison of actual aid allocations with the CD poverty efficient allocations implies the need for a substantial shift towards countries with high poverty, particularly those pursuing good polices. ‘The general point is that the optimal allocation of aid for a country depends on its level of poverty, the elasticity of poverty with respect to income, and the quality of its policies’ (Collier and Dollar, 2002: 1489). Various allocations are simulated and CD conclude that a more efficient targeting of aid towards countries with high rates of poverty and that are following good policies could almost double the number of people lifted out of poverty. While ‘the present allocation of aid lifts 10 million people permanently out of poverty each year, with a poverty-efficient allocation this would increase to 19 million per year’ (Collier and Dollar, 2002: 1498).

In the model, the major increases in aid allocation are to South and Central Asia, Sub-Saharan Africa and East Asia. As with any aid allocation model, there is a particular problem accommodating very populous countries, in this case especially if they have large numbers of poor people: India is the specific problem, and its allocation is constrained (countries such as China, Nigeria, Bangladesh and Indonesia also represent a problem in allocation). Such countries get ‘too little’ aid in actual as compared to simulated allocations because an allocation fully in proportion to their poor population would absorb most of the budget. There is also difficulty dealing with very small countries as they get ‘too much’ aid in actual as compared to simulated allocations, especially if an aid per capita measure is used. In practice, donors address this problem in an *ad hoc* way by imposing some minimum and maximum allocations (CD constrain the amount to India). This problem (which is non-trivial and has implications for the concept of equity applied) should be recognised in discussing allocations, and especially in drawing inferences that amount to value judgements about one allocation being better than another.

As Beynon (2001) observes, the underlying presumption is that a selective reallocation of aid to ‘good policy/high poverty’ countries will maximize the impact of aid on reducing poverty. Although the CD approach places considerable emphasis on the importance of good policy, this factor transpires to be of minimal actual importance in determining their poverty reducing aid allocation. Beynon (2001) reanalyses the data and shows that even in CD’s own model the impact of re-allocating aid on the basis of poverty criteria is bigger than re-allocating aid according to policy criteria, i.e. the reallocation is driven by the cross-country incidence of poverty rather than by variations in policy. Collier and Dollar (2004: F247) acknowledge this and point out that the 'good policy' criterion effectively operates between countries with similar poverty levels to prevent allocation away from those with fairly good policies (e.g. Uganda) towards others with relatively bad policies (e.g. Sudan).

Even those we have classified as aid pessimists have acknowledged improvement in recent years. 'Aid has now been shown to be effective in reducing poverty, in reducing the risk of conflict, and even in assisting policy reform' (Collier and Dollar, 2004: F267). There is some evidence that policies have improved since the 1990s and that aid allocations have become more responsive to the quality of policy. However, Nunnenkamp *et al* (2004) find little evidence that the targeting of aid has improved significantly. Although most donors and donors combined provide more aid to relatively poor countries (measured as per capita income), it is less evident that there is an increased focus on recipient countries with large numbers in absolute poverty, or that there has been a reallocation to countries with 'better' policy. They also reject the proposition that multilateral donors target aid at recipients with good policies more than bilateral donors. Thus, although the rhetoric of aid reallocation places emphasis on good policy, the reality tends to be a focus on where the greatest number of poor people are.

3 AID, PUBLIC GOODS AND WELFARE

In the 'public goods approach' to aid, well-being can be interpreted as increased access of the poor to public social services (especially health, education and sanitation) in addition to increasing the consumption of the poor (reducing income poverty). These may be narrow concepts of well-being, but they are appropriate to the remit of aid policy. Aid can improve well-being directly (through donor-managed projects), indirectly through growth (if this is in some sense pro-poor), and indirectly through aid finance for the provision of public goods (especially public expenditure on social sectors). Given a general belief that aid cannot be accurately targeted on the poor, the objective of enhancing well-being has in practice been addressed by financing social sector spending in the poorest countries or allocating aid to countries where it is most likely to benefit the poor (typically in terms of evidence that growth is in some sense pro-poor).

In the poorest developing countries which are major recipients of aid, and for which aid finances a large proportion of government expenditure, it is inevitable that aid receipts influence public social sector spending. In general, one would expect the level of social spending to be higher in countries that receive more aid, *ceteris paribus*, especially to the extent that aid is increasingly targeted on supporting social sectors (for example, as part of a poverty reduction strategy). This effect may be direct, if aid finances additional social spending, or indirect, if aid supports growth so that over time social sector spending (as a share of total spending and/or of GDP) increases. A more interesting question may be on the effect of aid on the efficacy of social spending, that is, on the effectiveness of spending in increasing welfare. Recent literature on the effect of aid on welfare and poverty indicators can shed some light on these issues.

There are two general arguments for (increasing) spending on social sectors. First, it finances the provision of and therefore increases access to public goods, which would be underprovided otherwise, and contributes to welfare; to the extent that the latter includes improving the quality of human capital this contributes to growth. Second, there are equity arguments as spending on social sectors is the type of government expenditure most likely to increase aggregate welfare and to benefit the poor. Higher levels of social sector spending do not ensure that the poor are better off, as the incidence of benefits from spending may be unequally distributed. For example, evidence for sub-Saharan African countries suggests that the poorest are the least likely to benefit from health and education spending (Castro-Leal *et al,* 1999); in Madagascar and Tanzania the benefits of increased access to health and education services were least for the poor (Morrisson, 2002). Even if the incidence of spending is regressive (the poor derive least benefit), spending on social sectors tends to provide some benefit to the poor and are the areas of public spending most likely to contribute to welfare indicators, especially health and education (Gupta *et al*, 2002; Dabla-Norris *et al,* 2004). Lanjouw and Ravallion (1999) argue that the poor are more likely to benefit as public spending increases, both because the share of social in total spending rises and the distribution of spending improves. As aid financing has the potential to leverage upwards the level of social spending, the potential to benefit the poor may be enhanced.

There are two characteristics intrinsic to the definition of a (pure) public good. A good is non-excludable if the benefits can be enjoyed by everybody in the relevant population when the good or service has been provided. A good is non-rival if one individual's consumption does not diminish the amount available to others. The former implies that the market mechanism would under-supply a public good, while the latter implies that society benefits by increasing provision. Because exclusion is difficult or costly the market cannot force all beneficiaries to pay a price (due to free-riding) so public provision, or a public contribution to the cost of provision, is necessary to ensure the socially optimal level of a public good is provided. In the case of non-rival benefits 'it is inefficient to exclude anyone who derives a positive benefit, because extending consumption to more users creates benefits that cost society nothing' (Kanbur *et al*, 1999: 61).

Social sector services, specifically health, education and sanitation, are good examples of (impure) public goods – they are not purely non-excludable or non-rival, and often they are one but not the other. What is most important is not the intrinsic public good nature, but the importance of externalities. Poor sanitation, lack of access to clean water or health care all increase the incidence of disease and ill health in society; the external bad (or public bad) is that the risk of disease is greater for all in society. The public good is reducing this risk (reducing or eliminating a negative externality), and it is provided by investing in health and sanitation. Whilst improved sanitation or access to clean water in a village is rival and excludable from the perspective of other villages, the population in other villages can still benefit from the reduction in water borne disease. If a vaccine is given to one person the same vaccine cannot be administered to another person (it is rival in consumption), but the other person still benefits from the general reduction in the probability of contracting the disease (an external benefit that is non-excludable). There may also be scale benefits by vaccinating many people at the same time.

As there is a public good element in providing social services (at least insofar as negative externalities are reduced), if aid supports increased provision it contributes to improvements in welfare (from which the poor are likely to benefit). Gomanee *et al* (2005, Appendix) provide some evidence on the effect of aid on the level of social sector spending (*Gs* measured as spending on health, education and sanitation expressed as a share of GDP). Although aid may affect the level of total spending the test is whether, *ceteris paribus*, countries with higher aid revenue allocate a greater share of GDP to expenditure on social sectors. They find that aid is a significant determinant of *Gs* for their sample and for the sub-sample of low-income countries (aid is not significant for middle-income countries). There is some evidence that aid encourages higher social spending in poorer countries, although the effect (coefficient) is small. Mosley *et al* (2004: F226) also find that aid has a positive and significant effect on the level of social sector spending (although they find no significant effect on health spending alone).

One issue of concern is that although aid contributes a large share of public spending in low-income countries, it has only a very small impact on the level of social spending. One possibility is that aid is not actually directed at social sector spending (it may, for example, be used to finance investment in infrastructure). Another possibility is fungibility, where aid intended for social spending is used for a different purpose, or that the aid is not additional (even if the aid is all allocated to social spending, tax revenues previously allocated to social spending may be reallocated elsewhere). The effect is that social spending does not increase by the full amount of the aid allocated to social spending. McGillivray and Morrissey (2004) argue that fungibility tends to be overstated as a concern: even if spending on specific areas does not increase in line with aid immediately, over time the spending allocation to areas favoured by donors has increased. In simple terms, aid is an important reason why the level of social sector spending in poor countries is increasing (and in the poorest countries is probably the only way of maintaining any reasonable level of social spending). It seems quite likely that as aid is increased social spending can rise more than proportionally.

A major concern is that whilst aid can increase the level of social spending, this spending is not very effective in delivering public goods and services (especially in ensuring access for the poor). The notion of the efficacy of public spending relates to evaluating how effective spending is in delivering the intended outcomes: to what extent does spending on primary health reduce infant mortality, or does spending on primary education deliver increased educational attainment? The available evidence suggests that the efficiency of spending is quite low in poor countries. In simple terms, controlling for various country characteristics, in the poorest countries expenditures are only achieving 60-80% of the outcome levels that could potentially be achieved, with rates below 50% for many countries in sub-Saharan Africa (Rayp and Van de Sijpe, 2007). Administrative and institutional weaknesses, and no doubt corruption and staff with low skills, mean that public spending is simply not delivering the benefits that could be expected.

There are a few studies that examine the effect of aid on indicators of human development (aggregate welfare measures) or poverty, and that include a measure of social sector spending. If the efficacy of social spending in delivering public goods is interpreted as the effect of such spending on indicators of welfare, then one can draw inferences from these studies. The studies we consider use any of three welfare indicators: the human development index (HDI), infant mortality and poverty headcount. The HDI is an index of measures of different dimensions of quality of life, notably longevity, education and access to resources (measured as real per capita GDP in purchasing power parity dollars). The infant mortality rate (IMR) is the number of deaths in infancy per 1000 live births, and tends to be a good proxy for average household welfare that is highly correlated with poverty. The headcount poverty measure is the percentage of the population deemed to be living below some established poverty line.

At the aggregate (country) level, indicators of human welfare such as the HDI or IMR tend to be correlated with indicators of poverty. Furthermore, non-monetary indicators of welfare, such as infant mortality, may be preferable to capture the material hardship aspect of being poor. Improvements in aggregate welfare (better health and education for example) may benefit the lives of the poor just as much as reductions in income poverty. For example, if health spending is not associated with reductions in infant mortality it is unlikely to contribute to improving the well-being of the poor. Is there any evidence that the (increased) social sector spending financed by aid is associated with improvements in welfare or reductions in poverty? The answer is yes, although the evidence is not especially strong.

Gomanee *et al* (2005) assess the effect of aid and social sector spending (*Gs*) on measures of aggregate welfare (HDI and IMR). The data is a panel of four four-year and one five-year period averages over 1980 to 2000 for 104 countries (not all variables are available for all countries in all periods so the actual sample in regressions is smaller). They find fairly robust evidence that aid does increase welfare measured by HDI, and this effect (the coefficient) appears to be greater for low-income than for middle-income countries. As income is a major component of the HDI, and the correlation between HDI and GDP across countries is high (although not perfect), this is largely evidence for an effect of aid on or through growth. The coefficient on *Gs* is insignificant overall and for low-income countries: in such countries they find no evidence that public social spending (and aid that finances such spending) contributes to increasing welfare. Public social spending does seem to increase welfare in middle-income countries.

They also find fairly robust evidence that aid is associated with lower levels of IMR (higher welfare), although in this case the effect appears to be greater for middle-income countries. The coefficient on spending is insignificant in all cases. Overall, the evidence is that aid does contribute to welfare (more so for HDI than IMR). In general, public social spending does not impact on welfare (except for HDI in middle-income countries, but aid is not a significant determinant of *Gs* in these countries). Spending on sanitation and health are significantly higher in middle-income compared to lower income countries. This suggests that the effect of aid on welfare is not through government spending, but either through donor projects or growth. This issue is returned to below, but policy implications are that it may be more useful to address the ineffectiveness of public spending rather than trying to increase aid or, if additional aid is provided, channels other than through government spending may be most effective.

Two other papers adopt a similar methodology but, using different samples and alternative econometric approaches, find that aid is associated with higher welfare or lower poverty through the effect of aid increasing public social spending. Mosley *et al* (2004), using data for some 46 countries in the 1990s, estimate simultaneously the effect of aid on social spending (or only health spending) and the effect of total (health) spending on poverty (infant mortality). They find that aid is associated with higher levels of social spending, and this is associated with lower levels of headcount poverty. Although higher health spending is associated with lower infant mortality, they find no evidence that aid is associated with higher health spending. Thus, in contrast to Gomanee *et al* (2005) who only find effects of aid directly or via growth, they only find effects of aid operating through public spending. The difference can to some extent be attributed to different samples and approaches, although it is notable that both studies had weaker results for infant mortality (that is, cross-country variations in IMR are difficult to explain adequately in these models).

Gomanee *et al* (2004) use quantile regressions for a sample of 38 countries, and again find that aid is associated with higher social sector spending, and this spending is associated with higher welfare. The novelty of the quantile regressions are that they allow one to consider differences in the effect of aid for countries at different parts of the welfare distribution. Gomanee *et al* (2004) find that the marginal impact of aid (via spending) appears to be greater for countries with lower levels of the welfare indicator (the poorer countries). Although they do not find that aid impacts on welfare directly or through growth, in line with Gomanee *et al* (2005) they do find that aid can have a greater impact in poorer countries.

While the results from different studies are not entirely consistent, there is robust evidence that aid improves welfare indicators, HDI and IMR, and tends to reduce poverty. The evidence is less conclusive on whether the effect is predominantly through direct impacts (aid provides incomes or social services) and growth, or through aid-financed social spending. The beneficial effect of aid is present for low-income and middle-income countries. In the case of middle income countries, although social spending is associated with increased welfare (for the HDI measure), aid is not a significant determinant of public social spending. If anything the marginal impact of aid is greater in the poorer countries, but this is not attributable to public social spending (which has a low or no impact). In the poorest countries there is evidence to support a policy of aid delivered through donor-managed projects, but the evidence suggests a major concern is the efficacy of public spending. Donors influence policy and practice on social sector spending and service delivery, and this can improve the effectiveness of spending (whether aid-financed or not).

The results reviewed above suggest that aid is effective in increasing welfare, but public spending (on social services) does not appear to be effective (except perhaps in middle-income countries), or at least is not consistently so when country characteristics are accounted for. An underlying reason is the low quality of public services (health clinics that do not have adequate staff or medicines, schools that have too few teachers or books). This is an endemic problem in the poorest countries and whilst in part it reflects a low level of social spending, a major concern is misallocation or misuse of spending.

Svensson and Reinikka (2004) provide evidence that in the early 1990s over 80% of the central government allocation intended for non-wage spending in primary schools in Uganda was never spent in the schools. They provide a model of local capture to explain why such a large proportion of the government funds leak from the process of decentralized spending. What is perhaps more interesting, although it receives less attention in citations, is that they also show that by the late 1990s following the implementation of expenditure tracking surveys and improved expenditure monitoring, the figures were reversed such that less than 20% of the funds leaked. In other words, techniques exist to ensure that most of the government spending allocated to a particular (decentralized) purpose are actually spent on the intended purpose. While there is no doubt that the efficiency of service delivery is limited, especially in getting to the poor, new techniques for monitoring expenditure and delivering services offer potential for improvement (Devarajan and Reinikka, 2004; Reinikka and Svensson, 2004).

4 AID ALLOCATION AND THE POVERTY REDUCTION DISCOURSE

The aid reallocation approach can be described as a discourse because of two distinguishing features. First, it is strongly associated with the World Bank – most of the contributions that can clearly be linked to this approach are written by researchers associated with the Bank (typically as current or former employees) and many are published by the Bank. Indeed, many of the citations in these contributions are by authors associated with the Bank. What emerges is a view promoted by, or at least shared by, the World Bank. Second, core phrases or propositions are frequently repeated (aid works in a good policy environment, growth is good for the poor). More generally, core themes are repeated and emphasized: good policy, good governance and growth are all necessary if aid is to be used most effectively to ensure that poverty is reduced. The core elements of the approach have been outlined above. Here we elaborate on three aspects of the discourse: aid and government behaviour (policy and governance); growth as the driver of poverty reduction and notions of governance and ownership in Poverty Reduction Strategy Papers (PRSPs).

Aid and Government Behaviour

The aid reallocation approach exhibits a deep-rooted scepticism regarding the behavioural response of recipient governments to aid and associated donor policy advice. This is encapsulated in the claim that donors should recognize that: ‘the impact of aid on growth depends on the quality of economic policies’, ‘the quantity of aid does not systematically affect the quality of policies’ and ‘aid resources are typically fungible’ (Collier and Dollar, 2002: 1476). The first relates to the literature on aid effectiveness and we have already noted that this claim has been challenged in the literature – it is not as clear-cut as implied. The second claim is essentially one that conditionality is ineffective; this too has been contested and challenged in the literature (Morrissey, 2005; Koeberle, *et al*, 2005; Mosley *et al*, 2004). Interpreted strictly the claim is true: the *quantity* of aid is not a determinant of the *quality* of policy, or the specific reforms advocated by donors are rarely fully implemented within the relatively short time period of the associated aid programme. However, there is considerable evidence that the direction and broad content of reform for the majority of recipients is in line with what donors advocate (Koeberle, *et al*, 2005). It is disingenuous to claim that donors exert no influence or that conditionality has no effect.

Notions of good governance are related to discussions of conditionality and policy reform, although more nuance is evident. Thus, ‘while aid has little impact on governance, governance has a substantial impact on aid effectiveness [and] aid allocations may well need to take into account the attained level of governance’ (Collier and Dollar, 2004: F264). The evidence that aid (donors) can improve governance is limited as democratisation and political reform is a slow process and political conditionality (the link to aid) is problematic (Burnell, 1994; Carothers, 1997). Available measures of governance are imprecise but suggest that, if anything, governance declined globally between 1996 and 2002. The deterioration is most evident for measures of ‘political stability’ and ‘rule of law’, whereas there is some suggestion of improvements in ‘regulatory burden’ and ‘government effectiveness’ (Kaufmann *et al*, 2003). Arguably, conditionality relates more to the latter so associated policy reforms may have reduced the burdens of regulation and increased the effectiveness of government. Donors need not assume that they cannot influence governance, although they are correctly reluctant to place too great an emphasis on such an objective.

We focus on the third claim, that aid is fungible and therefore not used for the purposes intended by donors. The core issue is whether the aid allocated to a particular area of expenditure by donors is all spent on that area and whether expenditure on that area increases by the amount of the aid (additionality)? The general argument is that recipients divert aid to government consumption spending rather than using it to finance growth-promoting investment (Burnside and Dollar, 2000: 863). World Bank (1998) was more concerned with specific fungibility, where total spending in a particular area, such as health, did not increases by the full value of aid allocated to that area. Because the data on the areas to which aid is allocated are of poor quality and existing studies adopt a very static analysis, the empirical evidence for fungibility is not strong (McGillivray and Morrissey, 2004). If one analyses the dynamics of expenditure within the context of the evolution of fiscal aggregates (including taxes and borrowing), it is apparent that over time spending increases in the areas targeted by donors and often total spending increases by more than the value of aid (McGillivray and Morrissey, 2004). Fungibility exists, but there is no evidence that it significantly distorts the way in which aid is used.

A related concern is that aid may discourage effort; if this occurs, total spending would increase by less than aid (as tax revenue falls) and, even if there is no fungibility there is unlikely to be additionality. Governments in developing countries face a formidable challenge creating an effective and efficient tax system (Tanzi and Zee, 2000) but this does not imply that tax effort is weak, i.e. that tax/GDP ratios are particularly low (especially given the tax base and structure of such economies). In sub-Saharan Africa, where aid/GDP ratios are high, tax/GDP ratios are actually high relative to other developing countries (Commission for Africa, 2005: 297). Keen and Simone (2004) provide an overview of tax policy in developing countries, noting how difficult it is to increase tax/GDP ratios in low-income countries. As an example, trade liberalisation (a policy advocated by donors that most recipients have implemented) is associated with foregone tariff revenues: whereas richer developing countries can 'recover' almost 40% of foregone revenue, poorer countries recover none (Keen and Simone, 2004: 324). The implication is that poor countries may raise as much tax as they are able: because they are poor, tax/GDP ratios are stagnant. The evidence on tax reform (again, typically an element of conditionality) is more promising: significant reforms to tax structure have been implemented in many countries, increasing efficiency (of the tax system and collection) and reducing distortions, especially given the reduced dependence on taxes on trade (Gemmell and Morrissey, 2005). There is some evidence that aid and conditions have contributed to improved fiscal management (Osei, Morrissey and Lloyd, 2005). Thus there is evidence that aid and the associated policy proposals (conditions) has contributed to improvements in tax and fiscal policy. The claim that donors cannot influence policy, in particular tax policy, or limit fungible uses of aid (claims typically present in the discourse) is challenged if not refuted by the evidence.

The Pre-eminence of Growth and PRSPs

We have already noted that growth is the route to poverty reduction in the aid allocation approach as donors should 'allocate aid among countries to maximize a weighted average of their growth rates' (Collier and Dollar, 2002: 1484). The issue we turn to now is to argue that the pre-eminence of growth also applies in Poverty Reduction Strategy Papers (PRSPs), which are part of the discourse insofar as PRSPS represent the clearest statement of World Bank policy on poverty reduction. In this context aid and debt relief are linked as under the highly indebted poor countries (HIPC) initiative countries seeking debt relief are required to establish a good record of implementing economic and social policy reform and prepare a PRSP indicating how they will tackle poverty reduction. Debt relief is in practice equivalent to aid; donors account for debt relief as part of their aid budget, while for recipients both represent an increase in resources at the disposal of governments. In practice the processes of seeking eligibility for debt relief and approval for PRSPs (and associated aid) are bound together.

To qualify for debt relief under HIPC, countries must demonstrate their ability for sound economic management through implementation of policy reforms over three years under IMF and World Bank programmes. Essentially, this implies implementing approved pro-growth policies, and these must be implemented first. If this is deemed satisfactory countries pass the decision point and must then implement a PRSP for at least a year to reach the completion point, after which debt relief is provided. Morrissey (2004) argues that the inherent defect with this approach is that the resources to fund pro-poor (social sector) expenditures are not released fully until the end of the process (which could take as long as six years), whereas pro-growth policies must be implemented at the start. It is generally easier to identify and implement pro-poor expenditures than it is to implement a pro-growth economic reform programme that includes pro-poor policies. This is so because although it is relatively easy to identify appropriate social sector spending needs, even if ensuring effective delivery is a major challenge, it is very difficult to design a coherent and feasible pro-growth policy strategy that will be pro-poor in its effects (Morrissey, 2004). If the primary objective is poverty reduction, and this is what the donors emphasize, the primary policy instrument is pro-poor expenditures; a pro-growth strategy is desirable, but treating it as a prerequisite does not seem warranted. In PRSP documents, the section on macroeconomic (pro-growth) policies comes first.

Ownership and Poverty Reduction

The aid allocation approach tends to argue that donors cannot influence policy, but this seems at least inconsistent with the way in which donors promote policy reforms such as PRSPs. Donors can and do influence government preferences for pro-poor policies, in particular the core features of a PRSP, which are effectively laid down by the World bank, and can promote a pro-poor agenda and help to establish commitment to poverty-reduction strategies. Proponents of the aid allocation discourse seem reticent to admit these influences, even if the intention of such influence is implicit. The discourse addresses this by promoting recipient government 'ownership' of the reform process as embodied in PRSPs, but one can question the extent to which a government can own a policy that, in its objectives and outline, is established by others (donors, and specifically the World Bank).

Morrissey and Verschoor (2006) try to unpack notions of ownership while recognizing that the nature of the policy environment in developing countries, and how donors interact with this, is central to the potential for implementing poverty reduction policies. Of central importance are government preferences for pro-poor policies and the domestic political willingness to promote a pro-poor agenda. If policy-makers engage in simple learning by doing, policy choices are based on information available to the government solely from its own past actions and relating to the policy. Ownership is clear in this model, as the government considers only its own beliefs and experiences. Social learning describes a situation where policy-makers acquire information on alternatives from beyond their own experience and expand the set of policy options by observing the policies chosen by other governments. In this case the policy itself is not owned, but adapting details to local conditions confers ownership of the policy content.

The aid allocation approach in conjunction with PRSPs represents a model of 'hierarchical social learning' where a donor signals which policy should be chosen (the Bank advocates PRSPs) and has some mechanism to encourage governments to adopt it (conditionality in some form). If the mechanism is effective, governments will choose the policy but do not own it in any meaningful sense, if ownership requires that the decision to adopt the policy and a significant part of the policy content originated from the government. Governments might be committed to policies they do not own, if they believe that some important form of support or recognition (such as aid) is contingent on adopting the policy. A sufficient condition for commitment to policy reform is that a government selects a policy that can be implemented and is believed to be superior to its current policy; PRSPs may be deemed superior to an alternative simply because they come with donor support and aid. Put simply, ownership is part of the rhetoric (or discourse), not necessarily a true description of the practice.

5 AID AND WHOSE WELL-BEING

Most of the literature on aid effectiveness is concerned with the impact of aid on growth. Something of a consensus is emerging that aid does have a positive but quite small impact on growth, although debate remains regarding the extent to which "good policy" is necessary to ensure aid effectiveness. A number of recent papers have examined the impact of aid on indicators of welfare or poverty, reflecting the increasing emphasis being placed on poverty reduction in policy debates, in particular arguments that the objective of reducing poverty requires an increase in aid to poor countries. In this context, while there is still concern that aid should promote growth, there is additional concern that aid should help to address the needs of the poor. As it is at least difficult for donors to target aid on poor households, the emphasis tends to be on ways of allocating aid or suing aid that are most likely to benefit the poor.

This paper characterizes two alternative approaches to using aid to achieve poverty reduction. The first concentrates on the allocation of aid across recipients with the primary focus on growth as the means to sustained poverty reduction and good policies as the key to impact of aid on growth. The alternative approach accepts that growth is not the only route to poverty reduction, and suggests that aid can contribute to improving the welfare of the poor by supporting the provision of public goods, especially social services. In this was aid can reduce poverty in ways that are independent of the impact of aid on growth. The two approaches are not incompatible: it is possible to believe that aid should be reallocated in favour of countries with a high incidence of poverty that are implementing good policies and to believe that more aid should be used to increase of households (including the poor) to public goods and services. This, however, ignores fundamental differences underlying each approach.

We have suggested that the first approach can be viewed as representing the prevailing World Bank-led discourse on aid and poverty reduction. Growth is seen the means to poverty reduction, indeed often as the only means, and good policy (defined as appropriate macroeconomic policies and/or high scores on the Bank's CPIA index) is considered necessary to ensure aid effectiveness (in delivering growth and by implication poverty reduction). A striking feature of this approach is that the poor are anonymous – poor households cannot be targeted by donors, and it is typically implied that they are not targeted by recipient governments (often depicted as corrupt and inefficient). If the poor do benefit it is indirectly via a growth-induced reduction in poverty. In this sense, it would be difficult to argue that the poor, or more relevantly the well-being of the poor (rarely if ever explicitly mentioned), are the core focus. Rather the core focus is on policy, growth and governance.

Consequently, if this approach serves the interests of the poor it does so only indirectly, it offers little by way of strategy to improve the welfare of the poor other than growth and good governance. Whose interests are primarily served by this approach? We suggest that it is the World Bank as an institution that requires the support of politicians in Washington DC. The Bank needs to argue that the policies proposed contribute to growth and poverty reduction, but to appease political interests the focus cannot be on redistribution and well-being, and must give emphasis to what Washington views as good policy and governance. The approach does all of this with the promise that the outcome of following the prescription will be reductions in poverty, hence the poor do benefit.

The alternative approach places greater emphasis on some indicator of aggregate welfare seen as capturing to some extent the well-being of the poor. In the context of aid, rather than simulating some allocation pattern the research is based on empirical evidence for the effect of aid on human development or poverty indicators that can at least be interpreted as measures of well-being. The focus is on measures to increase the provision of or access to public goods. Attempts to increase the targeting of expenditure in areas that are more likely to benefit the poor could yield a high pay-off if combined with improvements in social service delivery. The approach cannot claim to identify effects on the well-being of poor households (neither approach can), but it is better able to accommodate research and analysis that does focus on measures targeting the poor. Indeed that is the strength of the approach – to some extent, the well-being of the poor is the focus of the alternative approach. If one is most concerned with using aid to promote the well-being of the poor and identify ways in which it is the poor that benefit, the second approach offers more promise.

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