RESEARCH PROGRAMME ON RISK, LABOUR MARKETS AND PRO-POOR GROWTH

Project R7617: The Scope for Increasing the Poverty Leverage of Aid

END OF PROJECT FINAL REPORT TO DFID

MAY 2003

Researchers: Dr Oliver Morrissey, CREDIT, University of Nottingham and
Professor Paul Mosley, University of Sheffield

Aims: To evaluate the evidence on the inter-linkages between aid, policy, economic growth and poverty reduction.
To derive practical policy implications for how aid can be used to encourage implementation of pro-poor growth policies.

Objectives: i) to examine how the policy environment mediates the impact of aid on growth;
ii) to assess the effects of policy on the relationship between growth and poverty reduction (via poverty elasticities) and;
iii) to assess how aid can be used to influence policy and, in particular, the implementation of pro-poor growth policies.

DFID Project R7617: Poverty Leverage of Aid

END OF PROJECT FINAL REPORT

May 2003

Oliver Morrissey and Paul Mosley

Structure of Report

1. Background and Objectives

In two fundamental ways, the landscape of aid policy has changed in the last half-dozen years. The basic objective of *development* (usually interpreted as economic growth) in the recipient country has been replaced by the objective of *poverty reduction* (World Bank 2000). For most donors growth in the developing world is only valuable if it can be construed as pro-poor. Policy conditionality, until very recently seen as the main instrument for increasing the effectiveness of aid, has been replaced with a concept of *selectivity*, in which aid agreements are only concluded with those countries whose policies are in some sense already acceptable (World Bank, 1998, 2000; Collier and Dollar, 2002). For those many who support the first of these developments, it is important to know whether the second represents the most reliable route to achieving it. To discover whether it does was the principal objective of our research project.

The proposition that conditionality should be abandoned in favour of selectivity derives principally from the well-known finding of Burnside and Dollar (2000) that aid is only effective where policies are good, yet has no ability to influence those policies. However, there are three important reasons to hesitate before accepting this conclusion. Firstly, Burnside and Dollar's findings have been challenged, in particular by Hansen and Tarp (2001; see also Dalgaard *et al*. 2002), who argue that aid effectiveness is invariant with respect to policy. Secondly, the effective application of selectivity requires the donor to find enough poor countries with good policies to spend the aid effectively. This is difficult, particularly in Africa, where the majority of poor countries are to be found but there are very few governments who yet practise 'good policies' in the World Bank sense. Thirdly, selectivity can be regarded as an ex-post 'off the peg' form of conditionality. To the extent that the optimal policies differ between countries, defining a single set of optimal policies implies a lost opportunity.

Following these perspectives, the current position of the World Bank on aid effectiveness for poverty reduction rests on three premises. First, as donors are unable to effectively target aid on poor households, the only way that aid can be made to contribute to poverty reduction is if the aid contributes to higher growth rates. Second, aid is only effective in increasing growth in those countries with 'good' policies (what precisely such policies are varies between expositions). Third, it follows that the aid allocation that will achieve the greatest amount of poverty reduction is one that gives disproportionately more, if not all, aid to those countries with both many poor people *and* good policies.

The research project set out to explore and assess these arguments under three broad lines of research. The major component of the project was a series of cross-country econometric studies of how aid impacts on growth and, more importantly, how aid can impact on the welfare of the poor by financing pro-poor public expenditures and other variables influencing poverty (e.g. corruption and inequality). A second component addressed at a case-study level (Uganda, Ethiopia and Tanzania) how aid and the donor-recipient relationship influences the policy stance in recipient countries, in the context of the evolution of poverty reduction policies. A final complementary component modelled how aid spending can impact on household welfare.

2. Methods

We addressed the research objectives by means of two different approaches – cross-country econometric analyses to identify aggregate relationships between aid, growth and poverty, and country case studies to explore policy issues. The first of these was the primary focus of the project, and absorbed most time of the two research assistants (each of whom was part time on the project), Karuna Gomanee (based in Nottingham) and Arjan Verschoor (based in Sheffield). The case studies were conducted by interviewing officials and collecting data in visits to selected countries. Morrissey visited Kenya, Tanzania and Uganda a number of times in connection with the project, and Verschoor conducted more extensive fieldwork in Uganda. During fieldwork as part of a separate related project, June Rock collected data for a case study of Ethiopia.

The project made three main contributions to the *econometric analysis of the impact of aid on the poor* (i.e. on indicators of human welfare). The first was developing an econometric method to accommodate the fact that aid does not impact directly on either growth or poverty, but rather influences these outcomes via a transmission mechanism. The technique of 'generated regressors' was applied, and the transmission mechanisms identified were investment in the case of the impact of aid on growth (Gomanee *et al* 2002) and public spending in the case of the impact of aid on the welfare of the poor (Gomanee *et al* 2003). The second was collecting data on pro-poor public expenditure (PPE), and constructing various PPE indices (work conducted by the research assistants, Arjan Verschoor and Karuna Gomanee). The third was to use a variety of econometric approaches to test hypotheses regarding the effect of aid on growth, on poverty (and poverty elasticities) and on indicators of welfare. The main results are reported in the next section and elaborated in the Appendix, which summarises the main findings of the papers written under the auspices of this project.

Understanding how aid can be made more effective in supporting a pro-poor growth strategy (the *poverty leverage of aid*) requires country case-study methods. Morrissey (2001) provided an analytical framework to describe the policy environment for poverty reduction and identify where donor effort and influence are most likely to be effective. The framework is applied in a comparative study of PRSPs in three countries – Kenya, Tanzania and Uganda – and formed the basis for the more extensive studies of Uganda (Morrissey and Verschoor) and Ethiopia (Morrissey and Rock). The conceptual premise is that the potential for implementing poverty reduction policies is conditioned by the policy environment - government preferences for pro-poor policies and the political capacity to promote a pro-poor agenda. Persuasive economic arguments supported by relevant research can shape preferences while technical and financial support can enhance political capacity. The Ugandan case study was supplemented by some modelling exercises, including simulating the impact on households of increased (aid financed) health care spending (Chant and McDonald). The findings from the case studies and complementary papers are also summarised in the Appendix, although a number of these papers will not be completed until later in 2003.

3. Findings

The broad finding is that aid does contribute to growth, specifically by financing investment (i.e. investment is the transmission mechanism). Such growth may in turn reduce poverty, but the effect of aid in reducing income-poverty is very indirect. However, aid can have a more direct effect on alleviating poverty, as through the transmission mechanism of PPE aid is associated with higher levels of indicators of human welfare. The novelty of the findings is that the way in which aid alleviates poverty (financing pro-poor public spending) is different to the way that aid enhances growth (by financing investment). This section presents the principal findings from a number of the completed project papers.

Gomanee, Girma and Morrissey (2002) explain the technique of generated regressors, used in subsequent empirical analysis of the effect of aid on indicators of poverty, and applies it to study the impact of aid on growth. The paper also introduces the concept of transmission mechanisms that determine how aid influences growth rates. Previous studies failed to specify these mechanisms. They identify investment as the most significant transmission mechanism, and estimate the total effect of aid on growth, accounting for the effect via investment. Pooled panel results for a sample of sub- Saharan African countries over the period 1970 to 1997 point to a highly significant positive effect of foreign aid on growth. On average, each one percentage point increase in the aid/GNP ratio adds one-third of one percentage point to the growth rate. The results are robust to issues of endogeneity, outliers and country-specific effects. They conclude that Africa's poor growth record should not be attributed to aid ineffectiveness.

Verschoor (2002) reviews the literature on the incidence of public expenditure to identify which areas of public spending have acquired a reputation of being more pro-poor than others. Of particular importance are health care, education, water and sanitation, housing, social welfare, rural infrastructure, and agricultural research, training and extension. Improving the responsiveness of the public sector to poverty would imply a restructuring of public expenditures in favour of these sectors. The paper tests this proposition in a preliminary manner by obtaining estimates of the coefficients on public spending on pro-poor sectors for a pooled sample of 57 countries for the period of 1980-1998. Pro-poor expenditure (PPE) priorities contribute to explaining the cross-country variation in poverty reduction. Other project papers test the same proposition using more elaborate econometric techniques and obtain consistent results (see summaries in the Appendix)

Kalwij and Verschoor (2002) focus on identifying the percentage reduction in poverty due to a one-percent increase in income, i.e. the growth elasticity of poverty. Although the average relationship between growth and poverty reduction may be encouraging, the substantial residual variation around this relationship suggests the importance of a research focus on factors conducive not just to any growth but to *pro-poor* growth. *Mosley et al (2002*) extend this analysis in a broader cross-country context, to analyse the effect of aid on poverty including PPE as an explanatory variable; other factors, including corruption and inequality, also influence the poverty leverage of aid. Furthermore policy

conditionality appears, according to both our econometrics and our case studies, to 'work' at least in relation to PPE. One approach to increasing donor leverage on poverty is therefore to bring policy conditionality to bear on these variables, in particular the PPE index, which unlike the others is relatively easy for governments to manipulate. Aid to countries with a high PPE value, we argue, is likely to alleviate more poverty than aid allocated according to World Bank 'selectivity' criteria.

Gomanee, Morrissey, Mosley and Verschoor (2003) provide what is the culmination of the earlier papers on estimating the impact of aid on welfare (this is included as Appendix B). This paper finds that aid can improve the welfare of the poor via a transmission channel of aid-financed public spending on social services (sanitation, education and health), the index of pro-poor public expenditures (PPE). The hypothesis tested is that aid leads to increased PPE, either directly or indirectly (by releasing other revenues to be used for such purposes), and these expenditures increase the welfare of the poor. As comparative data on poverty levels are scarce, we use two indicators of the welfare of the poor, namely infant mortality and the Human Development Index (HDI). As part, if not all, of the effect of aid is via PPE, we allow for this by calculating a generated regressor that separates the effects of aid and PPE to obtain a coefficient on the aid variable that includes the indirect effects through public expenditure allocation induced by aid.

Estimation is based on a pooled panel of 57 countries over the period 1980 to 1998. We obtain results in support of our hypothesis: there is considerable evidence that higher PPE is associated with higher values of welfare indicators, and that aid contributes to the welfare of the poor by financing such expenditures. Higher levels of aid are associated with higher levels of PPE (both measured relative to GDP). We also find robust evidence that military spending is associated with higher levels of infant mortality (but had no significant effect on HDI), suggesting that the variable captures an effect of insecurity.

The results suggest that the composition of public spending holds the key to alleviating poverty. Attempts to increase the targeting of expenditure in areas that are more likely to benefit the poor could yield a high pay-off. Increasingly, aid is being used in this way, to support public spending as part of a Poverty Reduction Strategy. While research is needed to understand how to improve the effectiveness of public spending in targeting the poor, our results show that in general sanitation, health and education spending have been associated with alleviating poverty. Through supporting such spending, aid has benefited the poor. Research in the case study component of the project provided corroborating evidence and is reported in the next section.

The policy implications of the research are captured in what *Mosley et al (2002)* term the 'new conditionality' as applied to how aid can influence pro-poor policies:

- Donors should support multiple or continuous levels of commitment and withdrawal rather than a simple yes/no selectivity decision on whether to give aid or not. For example, a 'very good' aid recipient could receive programme aid for policy reform with accelerated debt relief. The best way to assist a 'moderate to poor' recipient may be by providing only social-sector aid (education, health, and rural infrastructure).

Where donors agree that a country is a ‘ hopeless’ recipient, there is a case for giving nothing at all.

- There are practical alternatives to donor-to-government provision, such as through NGOs or the private sector. This is an explicit recognition that not all policy levers are in the hands of governments ;
- Donors need to exercise pressure through social and political as well as economic channels. Increasingly, aid is invested in conflict prevention, promoting democracy and fighting corruption, for example, to build social capital.

Morrissey (2001) argues that donors can help to establish commitment to poverty-reduction strategies, but implementation requires increased spending in certain sectors. Developing countries have limited capacity to reallocate spending from domestic resources but aid can here play its traditional role of bridging a financing gap. Four measures to reform conditionality to promote and support pro-poor policies are recommended:

- Aid resources should be deployed to support pro-poor expenditures, the only condition being the existence of an expenditure strategy with monitoring arrangements and performance indicators.
- Debt relief should be initiated subject only to a PRSP plan being in place. This facilitates the initiation of pro-poor policies.
- Debt relief can be accelerated when an appropriate package of pro-growth policies is in place.
- Conditions should be part of a negotiating strategy used to encourage policy reform.

The core findings of the project can be summarised as:

First, although aid cannot be targeted on households, it can be targeted on the types of government spending that are most likely to improve human welfare and most likely to benefit the poor. Thus, aid can alleviate poverty by financing increased public spending on social sectors (health, education, water and sanitation).

Second, aid effectiveness in contributing to growth is not solely dependent on ‘good’ policy. Aid contributes to growth by funding (largely public) investment. Appropriate policies may make investment more productive, and may enhance the complementarity of public and private investment, and thereby increase aid effectiveness, but good policy is not necessary for aid to be effective.

Third, the best way to ensure that aid benefits the poor is to ensure that aid-financed public expenditure is on social sectors in countries with many poor people. It is necessary that appropriate expenditure plans and monitoring systems are in place, but this is less than the requirement of good policies.

4. Dissemination

The research output of the project has been regularly disseminated through discussion papers, some published as CREDIT Research Papers and others through a series of Occasional Papers under the *Research Programme on Risk, Labour Markets and Pro-poor Growth*. These papers have been mailed to relevant researchers and research institutes. In addition, all CREDIT Research Papers are available on the web, and the site is frequently accessed. Many papers have been submitted to journals, and a book is planned that will report on the findings of the research programme. The research has also been disseminated through conference and seminar presentations. A *Highlights* summary has been prepared for id21, and will also be disseminated via the CREDIT website.

Conference Presentations

Morrissey, O. (2001), 'Pro-Poor Conditionality for Aid and Debt Relief in East Africa', paper presented at the *WIDER Development Conference on Debt Relief,* Helsinki, 17-18 August 2001 (published as a *WIDER Discussion Paper*).

Mosley, P,.J. Hudson and A. Verschoor, (2001) 'Aid, poverty reduction and the 'new conditionality', *International Economics Study Group*, Gregynog, 15 September 2001 and conference at Centre for Development Research, Copenhagen, 1 November 2001.(at revise and resubmit stage with *Economic Journal*)

Mosley, P. (2002), 'Economic Crisis, Political Sustainability and the International Financial Architecture', presented at conference on *Towards a New Political Economy of Development; Globalisation and Governance,* University of Sheffield, 4-6 July 2002. (Forthcoming *Development and Change,* 2003*).*

Mosley, P. (2003), 'The World Bank and the reconstruction of the 'social safety net' in Russia and Eastern Europe', presented at the conference *on The Impact of globalisation on the nation-state from above*, Yale University, 25-27 April 2003

Session at *DESG Annual Conference 2002* (18-20 April, University of Nottingham):

Arjan Verschoor and Adriaan Kalwij 'Aid, Social Policies and Pro-poor Growth'
Paul Mosley 'Aid Conditionality and Poverty Reduction'
Oliver Morrissey and Karuna Gomanee 'Evaluating Aid Effectiveness Against a Poverty-Reduction Criterion'

Seminars:

Morrissey presented seminars on 'Aid, Pro-Poor Expenditure and Poverty Alleviation' at CDS, University of Glasgow (December, 2002); IDC, University of Bradford (February, 2003); DFID Public Seminar, Kigali, Rwanda (April, 2003).

Proposed presentations:

Morrissey will be giving a paper on the case study findings and Mosley will be giving a paper on conditionality and the World Bank at the *DSA Annual Conference*, Glasgow (September 2003).

Gomanee and Morrissey are planning to present some of the econometric results at the *WIDER Conference on Sharing Global Prosperity*, Helsinki (September 2003).

5. Publications

Whilst a number of papers have been submitted to journals and some are forthcoming or at 'revise and resubmit' stage, none are published. We provide here only the list of Research Papers that have been published and are currently available**.** Some seven papers are still in draft form (listed as mimeos or 'in preparation' in the Appendix) but will be completed and published as research papers. The CREDIT papers are available at www.nottingham.ac.uk/economics/credit/ (under Research Papers).

Gomanee, K., S. Girma and O. Morrissey (2002), 'Aid and Growth in sub-Saharan Africa: Accounting for Transmission Mechanisms', *CREDIT Research Paper 02/05*.

Gomanee, K., O. Morrissey, P. Mosley and A. Verschoor (2003), 'Aid, Pro-Poor Expenditure and Poverty Reduction', *CREDIT Research Paper 03/03*. This has been submitted to *Journal of Development Studies* and is provided as Appendix B to this Final Report.

Kalwij, A. and A. Verschoor (2002), 'Aid, social policy and pro-poor growth', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 4*.

Morrissey, O. (2001), 'Pro-Poor Conditionality for Aid and Debt Relief in East Africa', University of Nottingham, *CREDIT Research Paper 01/15*.

Mosley, P. and J. Hudson with K. Gomanee (2002), 'Aid poverty reduction and the new conditionality', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 5*.

Verschoor, A. (2002), 'Aid and the poverty-sensitivity of the public sector budget', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 3*.

References

Burnside, C and Dollar, D. (2000). 'Aid, policies and growth', *American Economic Review,* vol.90, September, 847-868.

Collier, P. and Dollar, D. (2002) 'Aid allocation and poverty reduction', *European Economic Review,* vol. 46, pp. 1475-1500.

Dalgaard, C-J., H. Hansen and F. Tarp (2002), 'On the empirics of foreign aid and growth', *CREDIT Research Paper 02/.*

Gomanee, K., O. Morrissey, P. Mosley and A. Verschoor (2003), 'Aid, Pro-Poor Expenditure and Poverty Reduction', *CREDIT Research Paper 03/03*.

Gomanee, K., S. Girma and O. Morrissey (2002), 'Aid and Growth in sub-Saharan Africa: Accounting for Transmission Mechanisms', *CREDIT Research Paper 02/05*.

Hansen, H. and Tarp, F. (2000), 'Aid effectiveness disputed', chapter 4 in F. Tarp and P.Hjertholm(eds.), *Foreign aid and development: lessons learnt and directions for the future,* London: Routledge. Amended version forthcoming *Journal of Development Economics.*

Hudson, J. and Mosley, P. (2001), 'Aid Policies and growth: In search of the Holy Grail.' *Journal of International Development,* vol. 13, pp. 1023-38.

Kalwij, A. and A. Verschoor (2002), 'Aid, social policy and pro-poor growth', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 4*.

Morrissey, O. (2001), 'Pro-Poor Conditionality for Aid and Debt Relief in East Africa', University of Nottingham, *CREDIT Research Paper 01/15*.

Mosley, P. (2002), 'Economic Crisis, Political Sustainability and the International Financial Architecture', mimeo, Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth*.

Mosley, P.(2003) 'The World Bank and the reconstruction of the 'social safety net' in Russia and Eastern Europe', unpublished paper, University of Sheffield.

Mosley, P. and J. Hudson with K. Gomanee (2002), 'Aid poverty reduction and the new conditionality', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 5*.

Verschoor, A. (2002), 'Aid and the poverty-sensitivity of the public sector budget', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 3*.

World Bank (1998) *Assessing Aid: What Works, What Doesn't, and Why,* Washington DC: Oxford University Press for the World Bank.

World Bank, 2000, *World Development Report 2000/01: Attacking Poverty,* New York, Oxford University Press.

HIGHLIGHTS

Aid Does Benefit the Poor

The main finding of this research project is that aid does benefit the poor in recipient countries. Aid contributes to growth, specifically by financing investment, and in this way helps to *reduce* poverty (i.e. growth increases incomes and reduces the numbers below the poverty line). Aid can independently *alleviate* poverty by financing public expenditure which, because of its labour-intensity or because its beneficiaries are poor, reduces poverty. Such expenditures are identified as spending on primary health and education; rural water and sanitation; agricultural research and extension; and housing and other social expenditures. Aid can enhance the welfare of poor people (alleviate poverty) by increasing the levels of those expenditures that are associated with higher levels of human welfare.

The current position of the World Bank on aid effectiveness for poverty reduction rests on three premises. First, as it is not possible for donors to target aid on poor households, aid can only contribute to poverty reduction via growth. Second, aid is effective in increasing growth only in those countries with good policies. Third, and consequently, the aid allocation that maximises poverty reduction is one that gives disproportionately more aid to poor countries with good policies.

The findings of our research project challenge all three of these premises by demonstrating that aid can benefit the poor even if it does not contribute to growth. The way in which aid alleviates poverty (financing pro-poor public spending) is different to the way that aid enhances growth (by financing investment).

- Aid effectiveness in contributing to growth is not solely dependent on 'good' policy. Aid contributes to growth primarily by funding public investment, which in turn reduces poverty.
- Aid can also alleviate poverty by financing a mix of public spending which places increased emphasis on the sectors listed above and a decreased emphasis on military expenditure.
- Aid can be targeted on the types of government spending that are most likely to benefit the poor.
- The best way to ensure that aid benefits the poor is to ensure that aid-financed public expenditure is on social sectors in countries with many poor people.

The research provides a number of conclusions for enhancing the potential of aid policy to support poverty reduction strategies.

- Donors can effectively influence recipient policy by providing information on policy options and support for design and implementation. It is better if donors support and flesh out existing policy-making initiatives rather than suggesting or imposing policy choices.
- Mechanisms for expenditure management and monitoring can enhance the effectiveness of social expenditures for alleviating poverty. Even in countries with poor policies and weak institutions, aid can be targeted on social sector spending.
- A sustained donor-recipient relationship is the most effective way to enhance the poverty leverage of aid. Simple 'yes/no' selectivity decisions of which countries are to receive aid are not the most effective intervention strategy.
- Donors need to exercise pressure through social and political as well as economic channels. This includes engaging with civil society and the private sector.

Key Words: Aid, Poverty Reduction, Pro-Poor Public Expenditure

Sources:
The CREDIT papers are available at www.nottingham.ac.uk/economics/credit/ (under Research Papers).

Gomanee, K., O. Morrissey, P. Mosley and A. Verschoor (2003), 'Aid, Pro-Poor Expenditure and Poverty Reduction', *CREDIT Research Paper 03/03*.
Morrissey, O. (2001), 'Pro-Poor Conditionality for Aid and Debt Relief in East Africa', University of Nottingham, *CREDIT Research Paper 01/15*.
Mosley, P. and J. Hudson with K. Gomanee (2002), 'Aid poverty reduction and the new conditionality', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 5*.
Verschoor, A. (2002), 'Aid and the poverty-sensitivity of the public sector budget', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 3*.

Researchers and Funding:
DFID Project R7617 'The Scope for Increasing the Poverty Leverage of Aid' (2001-03), lead by Oliver Morrissey and Paul Mosley. This is part of the *DFID Research Programme on Poverty Analysis, Monitoring and Pro-Poor Growth* (Universities of Cambridge, Nottingham, Sheffield and Open University).

Contact: Dr Oliver Morrissey, CREDIT, School of Economics, University of Nottingham, Nottingham NG7 2RD (fax +44 (0)115 951 4159) oliver.morrissey@nottingham.ac.uk

Submitted by Oliver Morrissey, May 2003.

RESEARCH PROGRAMME ON RISK, LABOUR MARKETS AND PRO-POOR GROWTH

Final Report for Project R7617:

The Scope for Increasing the Poverty Leverage of Aid

APPENDIX A: SUMMARIES OF RESEARCH PAPERS

The research output of the project has been regularly disseminated through discussion papers, some published as CREDIT Research Papers and others through a series of Occasional Papers under the *Research Programme on Risk, Labour Markets and Pro-poor Growth*. While many of the papers are linked and build on each other, to review the results of the project it will help to group the papers under three headings. First, a series of conceptual and empirical (econometric) papers analysing the relationship between aid and growth, and aid and indicators of the welfare of the poor. Second, a set of papers dealing with donor leverage on pro-poor policies and expenditures. Third, a set of papers are being completed that use Computable General Equilibrium (CGE) models to simulate the effect of aid and 'pro-poor policies' on the welfare of poor households.

1. Empirical Studies of Aid, Growth and Poverty

Gomanee, K., S. Girma and O. Morrissey (2002), 'Aid and Growth in sub-Saharan Africa: Accounting for Transmission Mechanisms', *CREDIT Research Paper 02/05*.

Gomanee, K., O. Morrissey, P. Mosley and A. Verschoor (2003), 'Aid, Pro-Poor Expenditure and Poverty Reduction', *CREDIT Research Paper 03/03*.

Kalwij, A. and A. Verschoor (2002), 'Aid, social policy and pro-poor growth', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 4*.

Kalwij, A. and A. Verschoor (2003), 'Meeting International Development Targets through Economic Growth and Social Spending', mimeo, DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

Mosley, P. (2002), 'Economic Crisis, Political Sustainability and the International Financial Architecture', mimeo, Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth*.

Mosley, P. and J. Hudson with K. Gomanee (2002), 'Aid, poverty reduction and the new conditionality', mimeo, Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 5*.

Verschoor, A. (2002), 'Aid and the poverty-sensitivity of the public sector budget', Department of Economics, University of Sheffield, *Research Programme on Risk, Labour Markets and Pro-poor Growth: Occasional Paper 3*.

Verschoor, A. (2003), 'Aid and the Poverty Focus of Public Spending', mimeo, DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

The project made three main contributions to the econometric analysis of the impact of aid on the poor (i.e. on indicators of human welfare). The first was developing an econometric method to accommodate the fact that aid does not impact directly on either growth or

poverty, but rather influences these outcomes via a transmission mechanism (Gomanee and Morrissey, with Girma). The second was collecting data to construct various indices of pro-poor public expenditure, the PPE indices (Verschoor and Gomanee). The third was to use a variety of approaches to test hypotheses regarding the effect of aid on growth and on indicators of welfare (all researchers). A broad finding is that aid does contribute to growth, specifically by financing investment (i.e. investment is the transmission mechanism). Such growth may in turn reduce poverty, but the effect of aid in reducing income-poverty is very indirect. However, aid can have a more direct effect on alleviating poverty, as through the transmission mechanism of PPE aid is associated with higher levels of indicators of human welfare. These results are elaborated in the summaries of the discussion papers produced.

Gomanee, Girma and Morrissey (2002) provide a contribution to the literature on aid and growth. It contributes to project objectives in two respects. On a technical level, the paper explains and applies the technique of generated regressors, used in subsequent empirical analysis of the effect of aid on indicators of poverty. On an empirical level, it investigates the ways in which aid can impact on growth (which can be considered as a prior impact to any effect of aid on poverty reduction). Despite an extensive existing empirical literature in this area, studies have not paid much attention to the importance of transmission mechanisms in determining the influence of aid inflows on growth rates. In other words, existing studies have failed to specify the mechanisms via which aid should affect growth.

Gomanee, Girma and Morrissey (2002) identify investment as the most significant transmission mechanism, and also consider effects of aid via government spending and imports. With the use of residual generated regressors, they estimate the total effect of aid on growth, accounting for the effect via investment. Pooled panel results for a sample of sub Saharan African countries over the period 1970 to 1997 point to a highly significant positive effect of foreign aid on growth. On average, each one percentage point increase in the aid/GNP ratio adds one-third of one percentage point to the growth rate. The results are robust to issues of endogeneity, outliers and country-specific effects. They conclude that Africa's poor growth record should not be attributed to aid ineffectiveness.

Verschoor (2002) provides a review of the literature on measuring pro-poor public expenditure (PPE). Debates on aid-effectiveness imply the desirability of an aid-allocation policy that (1) gives priority to countries whose balance of public expenditures indicates a relatively strong determination to fight poverty, and/or (2) attempts to shift that balance through a process of policy dialogue and 'new' pro-poor conditionality. This paper addresses the kind of evidence that should inform a corresponding aid-allocation rule. Specifically, indicators of budgetary priorities are considered. In the literature on public spending, from benefit incidence assessments and among development practitioners, certain sectors have acquired a reputation of being more pro-poor than others. A not necessarily exhaustive list includes nutrition (for instance in the form of food subsidies), health care (especially basic health care), education (especially primary education), water and sanitation, housing, social welfare, rural infrastructure, and agricultural research,

training and extension. On the criterion of budgetary priorities, improving the responsiveness of the public sector to poverty would imply a restructuring of public expenditures in favour of these sectors. The paper tests this proposition in a preliminary manner by obtaining OLS estimates of the coefficients on public spending on pro-poor sectors for a pooled sample of 57 countries for the period of 1980-1998. Pro-poor budgetary priorities contribute to explaining the cross-country variation in poverty reduction. (Other project papers test the same proposition using more elaborate econometric techniques and obtain consistent results.)

Pro-poor public spending is not confined to budgetary priorities but includes aspects of the entire tax-transfer arrangement. This calls for a comprehensive fiscal policy evaluation that takes into account both present and future trade-offs in terms of poverty reduction between categories of spending. Although initial attempts have been made in the literature to quantify such trade-offs, such an evaluation must at present rely on a weak and deficient analytical and empirical base. As a result, aid-allocation decisions are of necessity ill-informed; Collier and Dollar (2002), for example, assume that as aid cannot be targeted on poor households, the only way it can affect poverty is via growth. This paper elaborates the strategy followed in the project, of targeting basic social services and basic agricultural development as the most likely spending areas to benefit the poor by increasing welfare.

To increase the poverty-reduction impact of aid through the medium of recipients' public spending requires recognition of a number of factors:

- Finding ways to *increase* the poverty-reduction impact of public spending calls for the assessment of *marginal* not average effects. The reason is that expansions of public spending programmes may alter the socio-economic composition and participation rates of beneficiaries.
- When recipient governments are required to match the aid-financed expansion of a public sector programme with finance of their own, the equity effects of alternative sources of finance will need to be considered.
- Provinces and government agencies may differ considerably in their targeting performance: the appropriate level of government and administrative unit should be favoured.
- The presence of administration costs implies that effective targeting is not the same as accurate targeting. Some excess coverage or 'waste' (i.e. benefiting those who are non-poor) is unavoidable in solving the problem of targeting as many of the poor as is possible.

Verschoor (2003) expands this analysis by providing econometric evidence in support of an aid-allocation policy that attempts to influence budgetary priorities in low-income countries and/or concentrates aid on poverty-focused public spending environments in both low- and middle-income countries. It builds a data set on pro-poor expenditures (PPE) for 57 low- and middle-income countries that has been developed for and used in all econometric work in the project. The data is used to test the links between aid and PPE on the one hand, and PPE and poverty, infant and child mortality, and human development on

the other. The main findings of OLS poverty and mortality regressions and 2SLS PPE regressions are

- Income per head and income inequality should both be controlled for when establishing a link between PPE and poverty and mortality reduction
- Both PPE and PPE-squared are associated with reductions in poverty and mortality, indicating that poverty-oriented budgetary priorities matter, and hinting at a so-called 'threshold effect', i.e. the increased impact of pro-poor spending when it exceeds a critical minimum level
- A measure of the absence of corruption, which in our context could be interpreted as a proxy for the benefit incidence of public spending, is associated with reductions in poverty and mortality
- When the endogeneity of aid is controlled for in a PPE regression, aid increases PPE in low-income countries but not so in middle-income countries

Kalwij and Verschoor (2002) develop and test an econometric model, the focus of which is the percentage reduction in poverty due to a one-percent increase in income, or the growth elasticity of poverty. By definition, the more negative the growth elasticity of poverty, the more growth is pro-poor. A research focus on factors conducive to growth when the ultimate concern is with poverty reduction may point in the right direction, considering recent evidence that *on average* the poor benefit as much from growth as the rest of society. However, although the average relationship between growth and poverty reduction may be encouraging, the substantial residual variation around this relationship suggests the importance of a research focus on factors conducive not just to any growth but to *pro-poor* growth.

The poverty indicators used in the paper are the percentage of the population living on less than $1 a day (corrected for purchasing power) and the infant mortality rate. Our data set covers the 57 countries for the period 1980-1998 for which the $1 a day poverty headcount measure is in the public domain. When estimating the model, we allow for country-level fixed effects, so that identification is solely based on changes over time within countries, which strictly speaking is the only effect that is relevant for aid-allocation decisions.

The main econometric findings are

- For a given quality of economic policies, the growth elasticity of poverty becomes more negative when given to countries with better social policies in place. Good economic policies influence the return on saving and investment, and aid impacts on growth by relaxing the foreign exchange constraint on investment. Good social policies – which we measure as public spending on sectors that promote widespread human development – encourage more inclusive or broad-based growth patterns.
- Aid independently increases the (absolute) size of the growth elasticity of poverty – that is, it has an effect over and above its influence on the budgets of governments with good social policies in place. This effect corresponds with aid that circumvents government budgets and impacts on poverty directly, for instance when allocated to NGOs engaged in activities that aim to reduce poverty.

- Aid has been (and therefore can be) used to encourage recipient governments to spend more on sectors that promote widespread human development.

The relevance of these econometric findings for the international distribution of aid is that aid can contribute to pro-poor growth (1) by favouring countries with both good economic policies and good social policies in place, (2) directly, for instance by sponsoring pro-poor NGOs, and (3) by encouraging recipient governments to spend more on pro-poor sectors.

Kalwij and Verschoor (2003) extend the analysis to focus on determinants of reductions in two indicators on the list of International Development Targets: the proportion of a country's population living on less than one dollar per day (corrected for purchasing power), and the infant mortality rate. A theoretical justification is given in terms of the capability approach of the link between human development spending (which expands the capability set of recipients of such spending) and the responsiveness of reductions in these indicators to economic growth. The 1990s witnessed a number of marked changes in the international community's attitudes and behaviour towards its poorest members. World summits and global conferences established quantifiable goals to serve as guideposts for development policies, chief among them the list of International Development Targets endorsed at many levels in the United Nations. Parallel to this tendency to establish targets for key social indicators, a tendency surfaced to make development aid more efficient in terms of achieving them, guided by selection. The principle of selectivity – the notion that international aid should disproportionately flow to countries with sound policies already in place instead of be used as a lever for changing policies – has proved controversial. This paper takes as its starting-point that selectivity should be among the aid modalities to be made use of (rather than the only aid modality) and searches for selection criteria that could contribute to its efficient implementation.

Using a first-difference estimator, Kalwij and Verschoor find strong and robust econometric evidence in support of the corresponding hypothesis that when public social spending has been consistently high for a sufficiently large number of years, the impact of economic growth on reductions in these key social indicators increases. The results are relevant to aid allocation insofar as countries are selected for aid on the criterion of the expected impact on monetary poverty and infant mortality reduction. Selection criteria should include both measures of the quality of the economic policy environment and measures of effective human development spending. The paper provides some quantitative importance of adding the latter set of selection criteria to the former by calculating the extra monetary poverty and infant mortality reduction implied by our estimation results: the order of magnitude of this difference is in the region of 30 to 50%.

Mosley (2002) examines some recent cases in which stabilisation, as a particular case of conditional aid, has failed for political reasons, in the process developing a model of political response to crisis. Alongside the 'standard' correlation of stabilisation failure with inequality and deficiencies in social capital, the paper discusses the ability of 'pro-poor expenditure' strategies to facilitate stabilisation by building social capital and thereby

providing fragile governments with a buffer against political instability. The main purpose is to show that several developing-country governments have shown awareness of the potential of pro-poor expenditure policies to achieve a double dividend, enhancing the implementing government's power-base, and making macroeconomic control politically more feasible in times of crisis. This is partly because pro-poor expenditure directly reduces social tensions and inequality, and partly because it increases the government's ability to manage such social tensions. This approach has implications for the international financial architecture; specifically, it helps to strengthen the case for capital inflow controls and for the IMF's Poverty Reduction and Growth Facility. The following issues for the 'international financial architecture' emerge from the discussion:

- it is possible for Governments to regulate the economy (adjust to crisis) increasingly through the use of exchange-rate based instruments which in general have the least social cost, and decreasingly through the use of indirect tax-based instruments and expenditure cuts involving redundancies amongst low-wage public sector staff.
- where expenditure-reduction methods of stabilisation are used, it is possible to use the PPE focus to prioritise the sectors which have greatest poverty leverage and thereby reduce the political risks associated with stabilisation.
- prevention is better than cure, and if it were possible to devise effective failsafe crisis early-warning indicators, that would be much more effective than all the mitigating measures commonly used.
- we not only need the IMF, we need the IMF in its new improvised role as supplementary aid donor, building on rather than throwing away the insight into developing-country political processes that experience with the Poverty Reduction and Growth Facility (PRGF) has painfully and belatedly given it.

Mosley, Hudson and Gomanee (2002) build on recent aid-effectiveness work on three fronts. Firstly, they examine the effect of aid on *poverty,* rather than on economic growth. Secondly, they show that the PPE index, together with inequality, is a key determinant of the poverty leverage of aid. Third, on the basis of this result, they argue for conditionality in a new form, already being tried out experimentally by donors, which gives greater flexibility to donors in punishing slippage on previous commitments, and keys aid disbursements to the level of the PPE index. This analysis challenges the recent World Bank approach (Collier and Dollar, 2002) which rejects conditionality in favour of selectivity – the allocation of aid to poor countries with 'good policies'.

Mosley et al. argue that aid *can* be an effective instrument in reducing poverty. Actual disagreements tend to centre upon the appropriate policy environment in which aid can be made to be at its most effective. Dalgaard, Hansen and Tarp (2002) argue that aid can be effective even under a bad policy regime. Collier and Dollar (2002) say that it is only effective under good macroeconomic and meso policies. This paper adopts an intermediate position. Good policies, we agree, are an important factor in reducing poverty but the Collier-Dollar definition of good policies is too narrow and restricted. In common with Collier and Dollar (2002), inter-country reallocations of aid could increase the poverty impact, and good macroeconomic policies have an additional effect on poverty reduction.

Whereas Collier and Dollar reject the conditionality approach in favour of 'selectivity', we continue to feel that conditionality – especially in what we define as its 'new' form – represents an important channel by which aid can reduce poverty. For credibility it is important that such conditionality be keyed to policy variables which have a demonstrable ability to reduce poverty independently of any impact on GNP. The PPE index represents one interim rule of thumb which can be used as a basis for new conditionality, and which is likely to alleviate more poverty than the current uncritical acceptance of the selectivity approach. The poverty leverage of aid is also influenced by, *inter al.,* corruption and inequality, but those are less easy for governments to manipulate.

Gomanee, Morrissey, Mosley and Verschoor (2003) combine the econometric techniques developed in Gomanee *et al* (2002) with the PPE data compiled by Verschoor (2002). This paper provides a test of the hypothesis that aid can improve the welfare of the poor, i.e. aid can help to alleviate poverty independent of any effects via growth of reducing poverty. Part of this effect is direct, if aid is targeted on the poor, and part is indirect, via a transmission channel of aid-financed public spending on social services (sanitation, education and health), the index of pro-poor public expenditures (PPE). The hypothesis tested is that aid leads to increased PPE, either directly or indirectly (by releasing other revenues to be used for such purposes), and these expenditures increase the welfare of the poor. As comparative data on poverty levels are scarce, we use two indicators of the welfare of the poor, namely infant mortality and the Human Development Index (HDI). As part, if not all, of the effect of aid is via PPE, we allow for this by calculating a generated regressor that separates the effects of aid and PPE to obtain a coefficient on the aid variable that includes the indirect effects through public expenditure allocation induced by aid.

Estimation is based on a pooled panel of 57 countries over the period 1980 to 1998. We obtain results in support of our hypothesis: there is considerable evidence that higher PPE is associated with higher values of welfare indicators, and that aid contributes to the welfare of the poor by financing such expenditures. Higher levels of aid are associated with higher levels of PPE (both measured relative to GDP). We also find robust evidence that military spending is associated with higher levels of infant mortality (but had no significant effect on HDI), suggesting that the variable captures an effect of insecurity. We also found the standard results that the welfare of the poor is higher in countries with higher GDP, and that poverty is higher in SSA, *ceteris paribus*.

The results suggest that the composition of public spending holds the key to alleviating poverty. Attempts to increase the targeting of expenditure in areas that are more likely to benefit the poor could yield a high pay-off. Increasingly, aid is being used in this way, to support public spending as part of a Poverty Reduction Strategy. While research is needed to understand how to improve the effectiveness of public spending in targeting the poor, our results show that in general sanitation, health , education and agricultural spending have been associated positively, and military spending negatively, with alleviating poverty. Through supporting such spending, aid has benefited the poor. Research in the case study component of the project provided corroborating evidence and is reported in the next section.

2. Donors and Pro-Poor Policy Reform

Morrissey, O. (2001), 'Pro-Poor Conditionality for Aid and Debt Relief in East Africa', University of Nottingham, *CREDIT Research Paper 01/15*.

Morrissey, O. and A. Verschoor (2003), 'Is Ownership a Meaningful Concept in Policy Reform? Policy Learning and The Evolution of Pro-Poor Policies in Uganda', mimeo, DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

Morrissey, O. and J. Rock (2003), 'Donors, Aid, Policy Learning and The Evolution of Pro-Poor Policies in Ethiopia', mimeo, DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

Morrissey (2001) provides a conceptual framework to examine how the conditionality inherent in HIPC debt relief should be constituted to promote pro-poor policies. There are two dimensions to this. First, the extent to which the policies proposed are pro-poor. Second, the potential for releasing resources for pro-poor expenditures. The paper provides an analytical framework to describe the policy environment for poverty reduction, and identifies where donor effort and influence are most likely to be effective. An illustrative application is made in a comparative study of PRSPs in three countries. Uganda is one of the leaders in the PRSP process, is already benefiting from HIPC debt relief and has achieved significant reductions in poverty. Tanzania has recently completed the PRSP process and hopes to qualify for debt relief. Kenya has also started on the PRSP process but has been much less successful in devising a poverty reduction strategy. The paper argues that the elements of debt relief conditionality should be tailored to the features of the poverty-reduction policy environment in each country and provides guidelines for the design of conditionality.

Implications for Conditionality

The basic argument of this paper is that the potential for implementing poverty reduction policies is conditioned by the policy environment in developing countries. Of central importance are government preferences for pro-poor policies and the political capacity to promote a pro-poor agenda. Taken together these create commitment. Persuasive economic arguments supported by relevant research can shape preferences while technical and financial support can enhance political capacity. Through such interventions donors can help to establish commitment to poverty-reduction strategies. A poverty-reduction strategy requires increased spending in certain sectors. Developing countries have limited capacity to reallocate spending from domestic resources to any significant degree, and limited ability to increase revenues. Aid can here play its traditional role of bridging a financing gap. In this context, debt relief (under HIPC) can be important to release resources for allocation to pro-poor expenditures.

Within the constraints of the policy environment, it is generally easier (but not easy) to identify and implement pro-poor expenditures than it is to implement an economic reform

programme that includes pro-poor policies. This is so because pro-poor expenditures are technically easier to design and to establish political commitment to. The binding constraint is resources, and donors can relax this (especially as new resources obviate the early need for domestic redistribution that can undermine reform and growth). Pro-poor policies, on the other hand, are more difficult to design and imply redistribution. They therefore require stronger political capacity and administrative capability. This problem is compounded by the disagreements and limited knowledge on the effects of economic reform on the poor. If the primary objective is poverty reduction, therefore, the prior policy is pro-poor expenditures, and this is a feasible implementation objective (conditional on the policy environment that prevails). Pro-poor policies, however desirable, are of secondary priority. They are more difficult to design and achieve, and external intervention can as easily be counter-productive as it is constructive. Pro-poor expenditures offer a first stage in building commitment and a foundation for pro-poor policies.

The current approach to HIPC conditionality reverses these priorities. The resources for pro-poor expenditures are only released after a record of policy reform has been demonstrated and after the basis of a pro-poor policy is outlined. Eligibility for the release of resources (aid and debt relief) should be based on pro-poor expenditure criteria. This is more simple, and more transparent, than eligibility criteria based on a package of economic reforms that interact in complex ways, are often contested regarding appropriateness, and can be undermined by poor economic performance (not infrequently due to events beyond the control of governments). Support for broader economic reform may require eligibility criteria, but these could relate to pro-poor policies and should not be a precondition for release of funds for pro-poor expenditures.

To facilitate future fiscal and debt sustainability, donors (who are the creditors) are justified in desiring pro-growth reforms, hence such reforms have been the basis for eligibility. Donor emphasis on poverty reduction lead to the addition of pro-poor policies under the PRSP in HIPC-II. These were not part of the eligibility criteria, and thus have implicitly been subject to softer conditionality based on performance indicators rather than the implementation record. Pro-poor expenditures are in a sense an add-on, being activities that support implementation of pro-poor policies. However, although the PRSP allows the debtors to set the performance indicators for the PRSP (pro-poor policies and expenditures), the IFIs in effect set the tighter pro-growth conditions for eligibility. Thus, tighter conditions (with greater likelihood of unsatisfactory compliance) are applied to pro-growth policies than apply to pro-poor policies. By implication, countries that could implement pro-poor policies, especially expenditures, are being at least constrained, if not prevented, from doing so by being denied eligibility. Reversing these implicit priorities could enhance the provision and effectiveness of debt relief.

Four measures to reform HIPC conditionality to promote and support pro-poor policies are recommended.

- Aid resources should be deployed to support pro-poor expenditures, the only condition being the existence of an *expenditure strategy, monitoring arrangements*

and performance indicators. On this criterion, Tanzania and Kenya would be eligible for increased aid to support social sector spending.

- Debt relief should be initiated subject only to a PRSP plan being in place. This facilitates the initiation of pro-poor policies. The minimum conditions for eligibility should not be very tight, otherwise countries trying to reform may be unfairly punished. Under this criterion, Tanzania would become eligible for immediate relief, and Kenya would be near to eligibility.

- Debt relief can be accelerated when an appropriate package of pro-growth policies is in place. The developing country should be allowed to establish the level of reform intended. The aim is to get countries moving in the right direction. In this way conditions can support or underpin government policy.

- Conditions should be part of a negotiating incentive strategy rather than as a coercive punishment strategy, and used to encourage rather than force policy reform. Conditions should be consistent and policy coherent.

Has the PRSP process enhanced the capacity of aid to contribute to poverty reduction? The answer is an unequivocal yes, but there remains considerable room for improvement. The requirements for broader economic policy reform, under our proposals, would be lessened and de-linked from initial debt relief. At the same time, increased aid (in the form of grants) would be targeted to support pro-poor expenditures.

Morrissey and Verschoor (2003) apply and extend the analytical framework outlined above to consider the influence of aid and donors on pro-poor policy development in Uganda, paying special attention to the meaning of the notion of ownership. Uganda is widely recognised as a country that has made significant achievements in implementing 'pro-poor' policies and spending over the past decade. Is this because Uganda owned the policy? The government was certainly committed to policy reform, but is this ownership? The paper provides an analytical framework for analysing policy learning, distinguishes between ownership and commitment, and describes the policy environment for poverty reduction. The Ugandan case is used to illustrate how donors can influence the process of policy learning. A sufficient condition for policy reform is that a government has available to it a policy alternative that can be implemented and is believed to be superior to the current policy. Ownership may be desirable, but it is not necessary.

An example of policy reform and evolution is needed to illustrate how ownership and commitment can be distinguished, and indeed to assess which is really the important factor, whilst identifying inputs by donors (or 'external agents' as a general term). We select the case of pro-poor policies in Uganda, as evidenced by the changing pattern of (donor-supported) public expenditures directed towards the poor, the evolution of a poverty reduction strategy and eligibility for debt relief under HIPC. Indeed, Uganda is seen as owning the reform process.

The paper begins by outlining a conceptualisation of the policy process, defining and distinguishing the concepts of ownership and commitment, and considering the role of external influences in the process. It then reviews the poverty reduction policies in Uganda, identifies actors that have played a role in the development of policy, and relates the strategy to the allocation of public spending. The main empirical section concentrates on the evolving pattern of public spending in more detail, asking to what extent the pattern has become more 'pro-poor' and assessing some evidence of the impact. The paper concludes that a sufficient condition for policy reform is that a government has available to it a policy alternative that can be implemented and is believed to be superior to the current policy. Ownership may be desirable, but it is not necessary.

Morrissey and Rock (2003) will complete a comparable case study for Ethiopia. This study, largely based on interviews with donors and government officials, seeks to assess the nature of external influence on the emergence in the 1990s of Ethiopia's pro-poor policies. Ethiopia's government is popularly perceived as owning its policies so completely that donors feel cut out of its reform process (and prefer to bestow their favours on other African governments that make them feel more welcome and needed). The observation that the aid that Ethiopia receives per capita is the lowest in sub-Saharan Africa, despite it being one of the region's poorest countries, suggests that there may be some truth in this popular perception. Although donors quote in their defence Ethiopia's limited 'absorption capacity' of financial aid, whether this capacity is indeed lower than in some other African countries that receive much more aid is a matter for debate. Paradoxically, a careful reading of the recent history of Ethiopia's reform process reveals that, whilst the Government remains firmly in control, external influence has been considerable.

On coming to power, in mid-1991, the EPRDF leadership was clearly reformist, as evidenced by the publication in October 1991, prior to any donor involvement, of its New Economic Policy setting out its acceptance of the need for some liberalization. This stated acceptance of liberalization was more a pragmatic response by the leadership to the failure of Ethiopia's command economy of the 1980s, rather than the result of any strong ideological commitment. But what the EPRDF didn't have was the financial and political (it had little or/no urban political support) capacity to implement reform. In 1992 the leadership thus sought external assistance (World Bank/IMF support), to get the much needed financial aid and, in particular, as a political substitute for lack of domestic support, through the adoption of structural adjustment.

Ethiopia's liberalization policy, implemented from late 1992 onwards, was partially donor driven, but the Government has retained strong control over the policy and has resisted donor pressure to quicken the pace of reform, in particular reform of the private sector. When pressure to change the latter was unsuccessful donors did not withdraw aid (although an IMF credit was withdrawn in 1997) but maintained a dialogue through financial and technical assistance. Donors were encouraged to persist with policy dialogue, in particular, because of the 'low levels of corruption' an increasingly important criterion for donors, and because of the existence of a coherent poverty reduction strategy.

The core of the Government's poverty reduction strategy is its Agriculture-led Industrialisation strategy (ADLI), which, in addition to liberalization of prices and markets, includes the extension of agricultural inputs (hybrid seed, fertilizers, pesticides) and credit to smallholders, and (to the frustration of some donors) a land policy that focuses on universal access to land in Ethiopia's rural communities. ADLI, implemented from 1994, is not a new initiative, but a legacy of the TPLF's pro-poor ideology and development initiatives carried out during its liberation struggle in Ethiopia's northern province of Tigray in the 1970s and 1980s. The policy emphasis at that time was on land reform, which from 1978 aimed at the redistribution of land to the poor and the landless, and the rehabilitation and development of the war damaged agricultural sector, through the provision, in the 1980s, of agricultural inputs, credit, and emergency food relief. These initiatives, together with the Front's policy, from the late 1970s, on the extension of basic social services (schools, health clinics, and vaccination programmes) underpinned the TPLF's victory and were certainly intended as investments in social capital.

The EPRDF's concern with social capital, in particular the protection of its core constituency 'the rural poor', is also reflected in its post-1991 expenditures. Since 1993, there has been a significant increases in social spending and, with the notable exception of the two-year Ethiopia-Eritrea war (1998-2000) when spending on defence returned to pre-1991 levels, a dramatic decline in defence expenditure (down from 35% in 1990 to 8% in 1994). Ethiopia's health and education sector programmes, formulated in the mid-1990s in collaboration with donor technical assistance, are home grown initiatives that prioritise extension of primary education and primary health care to Ethiopia's previously neglected rural communities. During the Ethiopia-Eritrea 1998-2000 war some donors chose to cut or withdraw their financial aid to these programmes. In sharp contrast, government spending on these sectors was maintained (a policy also rooted in the TPLF's struggle period, and one with lessons for donors). To the extent that there was a decline in the share of expenditures on these social sectors this was due not to a reduction in government spending, but rather to the increase in expenditure on other sectors, including defence, and the shortfall in donor funds.

Ethiopia's PRSP, a donor condition for HIPC debt relief, called Sustainable Development and Poverty Reduction Programme (SDPRP), was endorsed by the WB/IMF at end September 2002. The SDPRP, drafted by the Government in collaboration with donors (who provided financial and technical assistance, and contributions to, though not impositions on, content) is not a new initiative but rather an elaboration of the poverty reduction strategy that Ethiopia has followed in the 1990s. Poverty in Ethiopia is believed to have fallen from 52% to 44% during the 1990s, a slower fall than in Uganda over the same period, but fast by the standards of other African countries.

Ethiopia's recent history therefore leaves us with a paradox. Ethiopia appears to be the sort of country donors profess they want to give aid to: its reform policies are home-grown, it is a mature negotiation partner that is willing to concede but retains strong control, its policies have an explicit and effective poverty focus, it has low levels of corruption and it is one of the poorest countries in the world. On the other hand, donors do not appear to put their money where their mouth is. Donors need to be more aware of what the Ethiopian

government has actually achieved, rather than focusing on the areas where it resists external influence. Donors should appreciate that the nature of the control they can exert is subtly conditioned by the government's own preferences and what it perceives to be politically and economically expedient.

3. Simulations of the Effect of Aid on Spending and the Poor

Chant, L., S. McDonald and A. Verschoor (2003), 'Managing Commodity Booms: Policy Lessons from CGE Explorations of Uganda's experience of rising coffee prices', mimeo, DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

Chant, L., S. McDonald and O. Morrissey (2003), 'Aid Financing of Health Expenditure: A CGE Analysis of the Effect on the Poor in Uganda', (in preparation), DFID *Research Programme on Risk, Labour Markets and Pro-Poor Growth* (Sheffield, Nottingham, Cambridge and OU).

Chant, McDonald and Verschoor (2003) quantitatively assesses the medium term impact on growth and poverty reduction of alternative uses of a foreign exchange windfall, using the example of a coffee boom. When international coffee prices more than quadrupled in 1994, the government of Uganda responded to the perceived threat to monetary stability by introducing a coffee stabilisation tax. The tax was partly effective, as the exchange rate was held fairly stable, although evasion was widespread. Contrary to expectations, coffee farmers converted many of their liquid assets from the windfall profits into fixed assets. The coffee boom contributed in no small part to Uganda's buoyant economy throughout the 1990s, and was a factor in the spectacular fall in the poverty headcount measure.

The policy experiments, conducted using a dynamic CGE model for Uganda, assess the effects of using the windfall profits to fund a short term increase in investment by rural households (the base scenario), a short term increase in consumption by rural households, a one-off reduction in government borrowing, reductions in other tax rates for a constant internal balance and a short-term increase in government investment. The base scenario – investment by rural households – shows by far the largest impact on medium term growth and poverty reduction.

The paper infers from these experiments a role for development aid in economies plagued by export instability that reduces the risk of monetary instability, and thereby reduces the need for stabilising taxation that suppresses private investment incentives. Donors should commit themselves to counter-cyclical finance in order to equalise foreign exchange inflows over time. (This recommendation resonates with the finding of recent econometric studies that aid is more effective when it responds to negative external shocks.) An important precondition for the result to hold that aid can help turn commodity price spikes into medium term growth and poverty reduction is that a consortium of donors express a credible commitment to an equalising financing rule.