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The Good Governance Agenda: Who Wins and  
Who Loses.  
Some Empirical Evidence for 2001

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## **1. Introduction**

Many maintain that the provision of foreign aid to less wealthy countries is a long-standing initiative that dates back to the founding of the first relief organizations in the 18<sup>th</sup> and 19<sup>th</sup> centuries. Others contend that foreign aid for the purpose of development was initiated by Truman's speech in 1949, in which the expression 'underdevelopment' was first used.<sup>1</sup> Nevertheless, the necessity for the Western World to provide financial assistance to developing countries has been widely accepted. Poor countries need such assistance to further economic growth, alleviate poverty and increase the standards of living of their citizens. The World Bank (WB) (1998) estimated that foreign aid accounts for as much as 7 to 8% of a typical low income country's gross national product. The 2001 proportion, levelled at 6%, is still in line with these results. This makes foreign aid their primary source of external finance.

Foreign aid rose steadily through the 1960s to the 1980s, but peaked at around US\$60 billion in 1992 (Hook, 1996). The subsequent fall in aid flows of almost 12% in real terms (German and Randel, 2002) was due primarily to the end of the Cold War, the increase in private capital flows to least developed countries (LDCs), the financial difficulties of donor countries, and also on the 'aid fatigue' syndrome experienced by donors. The latter is mainly a consequence of the disappointing developmental outcomes in recipient countries. It has spurred a heated debate on aid effectiveness, since despite all the money given, many recipients remain in poverty.

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<sup>1</sup> Allen, T. (2003), DV-400 lecture notes, week 11.

In order to meet the United Nations' Millennium Development Goals, many believe that an increase in the amount of aid delivered to LDCs is necessary (Allen, 2003). However, critics of aid effectiveness have underlined the need to revisit the quality of such aid, and not only its quantity. In combination with the post-Washington Consensus and the focus on institutions and public sector management in the 1990s, a new policy agenda focusing on a more selective allocation of aid based on the quality of governance (henceforth referred to as 'selectivity') in recipient countries has come to be regarded by many as the key to aid effectiveness problem. Indeed, many donors, both multilateral and bilateral, have pledged to favour potential aid recipients having a better quality of governance. The actual practice of selectivity has not however been fully demonstrated by past aid flow analysis. Moreover, while the new agenda seems to be an amenable way to increase the efficiency of aid, the rhetoric has left aside the redistributive effects of such a change. The purpose of this paper is to use updated aid flow data to evaluate the degree of practice of selectivity by donors and attempt to demonstrate possible modifications in aid flows due to an increase practice of selectivity. This paper will show that, although the donor community's discourse stresses the need for more selectivity, its actions do not translate its intentions. In addition, it will demonstrate the existence of a significant negative bias towards low income countries, even towards some having governance quality above the sample average, when increased selectivity is practiced.

After reviewing some of the recent theoretical and empirical evidence concerning aid effectiveness, this paper will look at the emergence of the good governance (GG) agenda and selectivity-based aid allocation. The following section will inspect aid allocation in

practice. The most recent aid flow data will be analyzed to verify if donors have indeed introduced the good governance criteria as a basis for selectivity of aid recipients. Moreover, by means of an aid allocation simulation, the last part of the paper will examine which countries and regions would benefit or suffer from a reallocation of aid respecting the principle of selectivity based on good governance.

## **2. ODA and the Debate on Aid Effectiveness:**

### **2.1 ODA**

In order to discuss aid effectiveness, a functional definition of aid is first needed. Aid was officially defined in the 1960s by the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD) as Official Development Assistance (ODA). It encompasses all grants and soft loans (loans with at least a 25% grant component) given by DAC members to developing countries and territories (excluding countries in transition that instead receive 'official aid'). ODA includes emergency relief, humanitarian and technical assistance, but excludes military assistance and all financial flows from private organizations such as Non-Governmental Organizations (NGOs). Bilateral aid accounts for about 75% of total ODA, the remainder being in the form of multilateral aid. The goals of ODA, upon which its effectiveness is measured, are to increase the economic growth and welfare of recipient countries. Unless otherwise specified, the following discussion will refer to the aforementioned aid definition.

## 2.2 Evidence of Aid Effectiveness

Many studies have attempted to evaluate the effectiveness of aid even if, as noted by Cassen (1994), the dynamic nature of aid makes this a difficult task. Although micro-level studies have mainly uncovered a constant positive relationship between aid and growth, country-specific studies and macroeconomic analysis do not seem to yield as clear an answer.

There exist many country-specific success stories related to foreign aid. One only has to consider the recent experiences of Botswana, Uganda and Vietnam or the previous exploits of the Republic of Korea in the 60s and Indonesia in the 70s to realize that foreign aid can be part of the solution to underdevelopment. However, the tally of less successful stories is also very high. Indeed, many countries such as Tanzania and the Democratic Republic of Congo (more precisely Zaire under president Mobutu) have received large ODA inflows without delivering any concrete developmental outcomes.

Concerning the debate about the macro-level effectiveness of aid, until recently, the results were mixed. However, recent reviews of the literature (Hansen and Tarp, 2000; Moreira, 2003) seem to undermine the believed dichotomy between micro and macro level studies, dubbed the 'micro-macro paradox' by Mosley (1987). For example, Hansen and Tarp (2000) review and compare the methodological and econometric bases of most studies on macroeconomic effects of aid (131 cross-country regressions published from the late 60s to 1998) and come to the conclusion that, in fact, there is no micro-macro

paradox, and there does exist a positive relationship between aid and economic variables (investments, savings and growth).

This evidence is encouraging since all the money disbursed by donors has not been in vain. But the contradicting results of country-specific studies still sparkle doubts. Even though Cassen (1994:192) ventures that: “if asked whether aid has been a friend or foe, one would have to answer, on balance, a friend” and maintains that aid has reached its stated goals, many others believe that aid has not been as successful as it could have been in promoting economic development and welfare. For example, White (1998:3) remarks that “as aid flows have risen, economic performance has declined, and regions receiving increasing amounts of aid are doing the least well, particularly sub-Saharan Africa”. The necessity to increase the effectiveness of aid is therefore of prime importance.

In this line of thought, recent macroeconomic studies based on new growth theories have undertaken to explore possible omitted variables that could be conducive to greater aid effectiveness. The bulk of these studies have focused on elements of the environment of recipient countries, such as the quality of macroeconomic policies and governance in place. The ‘good policy’ debate will be briefly summarized here, while the ‘good governance’ aspect will be the focus of the next section.

### **2.3 Aid Effectiveness and Good Policies**

The testable assumption in many recent studies is that aid is more effective in countries having sound macroeconomic policies. Although this thesis was previously established

by other authors (for example: Stryker and Tuluy's, 1989; Killick, 1991 and Hadjimichael et al. 1995) it was Burnside and Dollar's (B&D) (1997) *Aid, Policies and Growth* and the WB's (1998) *Assessing Aid Report* that spurred the debate on the need for sound policies in recipient countries in order to boost aid effectiveness. According to these studies, good policies are seen to be those favouring the well functioning of markets. The range of policies considered was quite limited, focusing on trade, fiscal and monetary aspects, although they are in line with the Washington Consensus<sup>2</sup>. The authors come to the conclusion that aid has a positive impact on growth in countries implementing good policies, whereas it is much less effective in countries lacking them. Other supporters include Collier (2000), Collier and Dehn (2001), Collier and Dollar (2001) and Guillaumont and Chevet (2001). B&D also run an aid allocation regression and find that aid has not (bilateral donors) or only slightly (multilateral donors) been allocated to countries with such policies. They therefore conclude that greater selectivity based on the quality of policies should be adopted by donors in order to increase aid effectiveness.

However, B&D and the WB's studies have been strongly criticized. Two of the most persistent critics are Hansen and Tarp (1999, 2000 2001) who show that the result of B&D is not robust to model specification changes. Their main conclusion is that aid has a positive effect on growth, even in countries without good policies. Hansen and Tarp (2000), Dalgaard and Hansen (2001) and Dalgaard et al. (2002) also reject the aid

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<sup>2</sup> The term 'Washington Consensus' was dubbed by Williamson in 1989 and expresses a set of policy reforms targeted at Latin America. It was later 'borrowed' and applied more widely to neo-liberal policies aimed at increasing discipline, deregulation and liberalization in developing countries. These were thought to be the key to economic growth.



allocation policy implication suggested and opt for a model with decreasing marginal effect of aid on growth: “growth stimulating policies enhance the effect of foreign aid when expenditures are initially too low, while they lower the effect when expenditures are initially too high” (Dalgaard and Hansen, 2001:25). Lensink and White (2000) also refuse adopting selectivity based on good policies by criticizing the nature of ‘good’ policies, the changes in results due to alterations in model specification and the sample used and, lastly, the fact that an increase in aid could alleviate poverty through a channel other than growth.

The two studies have also been criticized for their simplistic assumptions. This is why Hudson and Mosley (2001) review the good policy premise using a system of simultaneous equations which includes a growth equation. This allows taking into consideration the interconnections between different variables and leads to the conclusion that “good policies appear to matter in stimulating growth, but they do not appear to impact on aid effectiveness” (p.1023). Finally, Easterly et al. (2003) give the *coup de grâce* to the B&D results by showing no robustness when filling in missing values in the original data, and updating the data to 1997.

Parallel to (and sometimes, intertwined with) the ‘good policy’ discourse, critics of aid effectiveness have also concentrated on another omitted variable affecting the relationship at hand: the quality of governance of recipient countries. It has been proposed that aid should be allocated not only on the basis of poverty, but also on the basis of governance in developing countries. The next section reviews the versatile

definition of good governance, the emergence of the good governance agenda and the theory behind its use in order to increase aid effectiveness.

### **3. GG in Theory:**

#### **3.1 Definitions of GG**

In order to discuss the relevance of GG in the aid effectiveness debate, one must first have a functional definition for this term. However, this is problematic as there is no single agreed-upon definition in GG. In fact, the vagueness of its meaning is one reason why this term has increasingly been utilized, as it can convey a slightly different meaning depending on who uses it. A note of caution is however expressed by Doornbos (2001) in referring to the applicability of this concept. He notes that its Western notion may not be universally applicable and that cultural contexts should be taken into consideration. The following discussion reviews the different approaches to GG.

Knack (2000) and others tend to use GG in a very narrow sense and limit its meaning to institutions only. The focus on institutions and their prime role in development has been increasingly important in the policy debate since the 1980s. As North (1995) puts it, institutions are the rules of the game, and the incentive structure of society. Brett (DV-406 Lecture Notes, October 8, 2003) defines them as “systems of rights and obligations in the form of recognized, formal or informal, but enforceable rules that enable individuals to cooperate to achieve common purposes by creating regularised role relationships”. Institutional quality, fostered by the government, is therefore necessary to provide a suitable environment for growth and development. It raises the confidence of economic agents in the performance of the system in which they operate and gives them

incentives to invest in the future. As Stern et al. (2002:8) point out, “countries that have combined institutional improvements with market oriented policy reforms and greater engagement with the world economy saw their capita incomes grow in the 1990s at the very rapid pace of 5 percent per year”.

Others extend the meaning of governance not only to the rules of the game, but also to the ‘players’ of the game, such as politicians and bureaucrats. This is the most familiar notion of governance and refers to the way the ‘players’ use their power and authority through the institutions in place in order to manage the resources available for growth and sustainable development. This idea of GG has been introduced and greatly used by the WB since the early 90s. For these reasons, the most common definition of governance is the WB’s: “the manner in which power is exercised in the management of a country’s economic and social resources for development” (WB, 1992:1). The WB also refers to GG as ‘sound development management’ and sees it as “central to creating and sustaining an environment which fosters strong and equitable development and it is an essential complement to sound economic policies” (WB, 1992:1).

The WB’s definition has been borrowed and slightly amended by many. Kaufmann, Kraay and Zoido-Lobaton (1999a,b, 2002) include in it the capacity of the state to effectively formulate and implement sound policies - which is in line with the ‘good policy’ prescription mentioned previously - , the respect of the state and the citizens for institutions that govern economic and social interactions and the aspects of the process by which those in authority are selected, monitored and replaced. The OECD’s (1995)

definition reflects the same idea as the WB's but also associates the term with democratization and participatory development. The OECD is of the view that four dimensions of GG are particularly important in order to achieve and maintain development. They are the rule of law, public sector management, control of corruption, and reduction of military spending. Neumayer (2003b) uses a similar definition of governance that incorporates elements of human rights, democracy and military expenditures. As for Levy (2002), he separates governance into two distinct components: while the first one relates to institutional governance and is measured by the extent of formal rule-bound governance as well as the credibility of political authority, the second component relates to organizational governance and is measured by the quality of the bureaucracy.

Apart from institutions such as the WB and the OECD, many individual donor countries have also adopted definitions of governance, as the focus on aid effectiveness shifted in this direction. In his treatise on foreign aid and political reform, Crawford (2001:70-71) reviews some of the definitions adopted by major donors. From his overview, the diversity of included GG components is noticeable. While the European Union adopts a broad view of governance, others restrict themselves to specific aspects. For example, the United States focuses on 'lawful governance', the United Kingdom puts more emphasis on the level of competence of the government in formulating policies, making decisions and managing service delivery. The Swedish are also concerned with public management and administration.

While the many definitions of governance preferred by different institutions and countries vary to some degree, they do convey the notion that the quality of institutions and public management is key to successfully developing countries. As the next section will demonstrate, it is also important to better aid effectiveness.

## **3.2 The Emergence of the GG Agenda**

### ***3.2.1 Failure of Economic Policy-Based Conditionality and Ill Effects of Fungibility***

Development thinking has greatly evolved since the 1950-60s, when the state was seen as the engine of growth. The transition in the 1970s led to a reversal of roles in the 1980s, when market liberalism became the panacea of underdevelopment. As of the late 1970s, the WB began to lend money conditional upon economic reforms referred to as the Washington Consensus, and other donors followed its lead soon after. While these reforms, based on deregulation, liberalization and fiscal discipline, were thought to unequivocally lead to a policy environment conducive to economic growth and development, the results of their imposition were not as positive as expected. Both the conception and implementation of reforms were to blame. Concerning the later, while the conditions were accepted and the financial assistance extended, the reforms themselves were not always implemented by the recipient countries. Due to the haste of donors in extending aid, LDCs were more than often given financial aid even though the attached conditions were not fulfilled. Many critics point their fingers at the adverse circumstances in recipient countries, characterized by inadequate institutional conditions, poor governance and a lack of incentive and willingness to pursue developmental goals (Straub, 1998) for the failure to implement conditions. It is practically impossible to

impose reforms onto governments that do not have the same priorities as the donors, especially those having a high discount rate for the future of their country.

One of the most vocal critics of the foreign aid enterprise, Peter Bauer (1991), maintains that aid is only a form of government-to-government subsidy and that it translates into a transfer of resources from poor people in rich countries to rich people in poor countries. Aid is seldom effective, he stresses, since it is very often targeted at countries whose governments do not show any interest in the fate of their people. Aid is rather used by those in power in order to fulfill their own interests, or to implement policies that are politically attractive but economically deadly, without any concern for the development of the country as a whole. Ethiopia and Burma were perfect examples of this in the 1980s. Boone (1996) adds that instead of fostering development, aid can in fact cause a poverty trap since it supports predatory governments that consume aid inflows instead of investing in their country and that implement distortionary policies for the benefit of the political elite.

While reform-based lending was in vogue, donors never completely stopped to fund individual projects. Because such financial assistance was in part given to countries lacking governance, the ill effects of fungibility were allowed to occur, which is another reason for the poor performance of aid. Fungibility denotes the idea that aid may fund projects that would have otherwise been undertaken by the recipient government, even in the absence of aid. The resulting consequence is that aid resources are being used by the recipient government for purposes other than the ones intended when the money was

allocated. Many empirical studies support this idea. Boone (1995, 1996) concludes that aid benefits mainly the recipient government since it raises the latter's consumption by about 75% of total aid receipts. Burnside and Dollar (1997) demonstrate that bilateral aid has a strong impact on government consumption, while the latter has no robust relationship with growth. The WB (1998) and Feyzioglu, Swaroop and Zhu (1998) also find that aid contributes in large part to government consumption. The former uses the latter's results to show that "the net effect of a dollar of aid is to increase public investment by 29 cents only, exactly the amount by which any dollar of government revenue would have raised investment" (WB, 1998:19). In countries where institutions, financial accounting practices and public management are weak, where decision-making is not transparent, and where rent-seeking and corruption are omnipresent, the ill effects of fungibility are facilitated and aid is less effective. The importance of fungibility and the failure of economic reform-based lending are related to an important element missing for aid to be effective: good governance.

### ***3.2.2 The GG Agenda and Political Conditionality***

In the 1990s, due in part to the poor performance of LDCs despite them receiving aid, significant changes in development thinking as well as in aid allocation practices gave rise to a more concerted focus on GG. Indeed, development thinking concerning the state's and markets' role for development shifted once more. This time, the balance came to a halt at a more equalitarian level: the liberal market was still seen as the means to achieve growth, but the state played an important role in establishing the necessary

environment for the well-functioning of the market. The post-Washington Consensus<sup>3</sup> emphasized the importance of institutions and public sector management in inducing such an environment. For example, Eggertson (1990; in WB, 1992:6) notes that “with respect to the rules, without institutions and supportive frameworks of the state to create and enforce the rules, to establish law and order, and to ensure property rights, production and investment will be deterred and development hindered”. Fostering the development of GG in LDCs became an important task for development practitioners: the GG agenda was born.

There however is a movement of resistance to the necessity of imposing GG onto developing countries to induce growth. It is mainly founded on the historically based observation that today’s developed countries did not experience their growth spurs in a context of GG and on the view that institutions as incentives is incomplete<sup>4</sup>. Nevertheless, the international community is still supporting the GG agenda, mainly due to the considerable empirical evidence concerning the relationship between GG and growth.

Since the late 1980s, a large body of empirical literature<sup>5</sup> has emerged, solidifying the presumed strong positive link between GG and developmental outcomes. In fact, different studies have focused on different aspects of GG (eg. control of corruption,

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<sup>3</sup> The post-Washington Consensus refers to the change in focus from economic reforms to a more comprehensive approach to development adopted by the WB while Joseph Stiglitz was Chief Economist.

<sup>4</sup> This was the topic of Mustafa Khan’s lecture entitled *The Good Governance Agenda and State Failure: A Recipe for More Policy Failures?* presented to DESTIN students as part of the Friday Visiting Lecture Series, March 21 2003.

<sup>5</sup> For a detailed list of studies exploring the effects of governance on developmental outcomes and covering the period 1985-2000, see World Bank (2000).



institutional quality, political stability, democracy, property and contract rights, civil liberties) and their effects on different growth-related outcomes. For example, Hall and Jones (1999) found evidence of a positive impact of GG on productivity and capital accumulation, while Kormendi and Meguire (1985), Mauro (1995), Clague et al. (1997) and Wei (1997) focused on domestic and foreign investments. Others have preferred to look at the effects of GG on human development, poverty and inequality. For example, using six composite indices representing different components of governance, Kaufmann et al. (1999) found that a one-standard deviation increase in any one of the indices translated into a decrease in infant mortality ranging between two-and-a-half and four-fold. Finally, the relationship between governance and economic growth itself has been the focus of a great number of empirical papers. Mauro (1995), Knack and Keefer (1995), Clague et. al (1997), Levine (1997), Rodrik, (2001) and Kaufmann and Kraay (2002) are but a few of the authors who found a positive relationship between the two variables. Rodrik (2001) even argues that governance is the primary determinant of growth, driving all of the other factors inducing growth. Although endogeneity concerns remain<sup>6</sup>, the empirical evidence linking GG and growth is quite robust.

In light of this evidence, the GG agenda argument applied to foreign aid implies that since countries with GG experience higher levels of growth, financial aid aimed at inducing and rewarding GG would result in increasing the growth and welfare of developing countries and hence to better aid effectiveness. In the donor community, this

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<sup>6</sup> See for example Mauro (1995), Knack and Keefer (1995, 1997), Huther and Shah (1998), Chong and Calderón (2000), and Kaufmann and Kraay (2002).

translated into a shift from economic reform conditionality to political/public reform conditionality.

The ‘new policy agenda’ for development, so dubbed by Robinson in 1994, therefore focused specifically on the promotion of human rights, democracy and GG in recipient countries. This was not only spurred by the disappointing results of economic reform-based lending, the renewed relevance of the state for development, and the empirical links between GG and growth, but also by the changing international environment brought on by the end of the Cold War. While the Cold War era was characterized by strategic allocation of aid to geo-political allies, the end of the conflict in the late-1980s/early-1990s gave the opportunity to the donor community to rectify their lending patterns. More attention was therefore paid to the context necessary to increase aid effectiveness. Donors began to promote not only good policies but also GG. For example, the WB’s increased its focus on capacity building:

“the World Bank recognizes the need for an institutional framework conducive to growth and poverty alleviation. Yet there is no certainty that institutional frameworks conducive to growth and poverty alleviation will evolve on their own. The emergence of such frameworks needs incentives, and adequate institutional capacity to create and sustain them. The World Bank, with other external and finance agencies, is involved in assisting developing countries build these incentives and develop such capacities” (WB, 1992:1).

Other donors focused on different aspects of governance such as commercial law, the rule of law, public sector management, accountability, transparency, control of corruption and judicial autonomy (WB, 1992, 1998; Burnell, 1997; Neumayer, 2003b).

As did economic conditionality, political conditionality suffered major downfalls and setbacks in its conception and implementation, and also failed to lead to the expected positive results. For example, Meyer (1992) reports that attempts to build sustainable institutions through donor-funded projects in the Dominican Republic failed mainly because the institutions were conceived according to donor specifications instead of local ones. Once donors stopped giving money, local leaders had no incentive to keep the institutions in place and returned to their old structure. This is evidence that conditionality does not work in countries where the government in place is not in control of the reforms and does not have the incentives and commitment to pursue the donor-specified changes. The aid allocation policy discourse concerning aid efficiency therefore shifted once more, this time towards selectivity.

### ***3.2.3 The GG Agenda, Selectivity and Aid Allocation***

As Burnell (1997:103) put it, “instead of achieving its aims of promoting economic development and welfare, in countries whose government does not have the right incentives, it [ODA] only helps maintain the underlying causes of poverty and underdevelopment”. The rationale behind selectivity is that since aid is used by governments as are any other funds collected (Feyzioglu et al. 1998), and since GG helps insure that this money is used for the benefit of the population at large, aid given to countries with GG has a greater chance of increasing economic development and welfare and hence, to be more effective. Selectivity is also a means to induce GG in developing countries. By withholding aid to countries with poor governance, donors create

incentives for potential recipients to better their governance. The end of the 1990s therefore saw a shift from conditionality to selectivity.

The empirical evidence concerning the effect of foreign aid on growth in well governed environments is less controversial than the debate concerning policies: it mostly demonstrates a positive relationship. Boone (1996) is one of the few to conclude otherwise. Comparing aid's effect in elitist, egalitarian and laissez-faire political regimes, he concludes that the impact of aid is not affected by the type of regime in place in the recipient country. According to him, aid does not increase growth, although it does increase government consumption, whether the government in place is repressive or liberal-democratic. This means that voice and accountability, corruption control, political freedom, and other GG components that are associated with democratic regimes do not increase the effectiveness of aid.

Using different GG measures, this finding has however been contested many times. For example, Isham et al. (1995) as well as Svensson (1999) analyzed aid effectiveness in countries with different levels of political and civil liberties. While the latter focused on the effect on growth and concludes that "aid has an impact on growth in countries with an institutional check on governmental power" (p.275), the former focused on the differentials in return to investment projects of governments, financed by the WB as its indicator of aid effectiveness. Although the authors found, as did Boone (1996), that the type of political regime does not impact aid effectiveness, they do establish that, in

countries with the most civil liberties, economic rates of return on investment projects are between 8% and 22% higher than in countries with the least civil liberties.

The WB (1997b) also used the same type of aid effectiveness indicator to find that in countries with sound development management, 86% of investment projects undertaken were deemed successful, which is significantly higher than in countries with poor development management. In 1998, the WB published the *Assessing Aid Report*, which concludes that sound economic policies and good institutional quality are key elements to alleviate poverty through increasing the impact of aid on growth. As a policy implication, it strongly suggests increasing the selectivity in aid allocations. According to this report, increased selectivity based on sound development management would allow 25 million people a year to be lifted out of poverty through a \$10 billion increase in aid, instead of only 7 million people without selectivity. Selectivity is, according to Collier and Dollar (2002), the way to maximize the poverty-reducing potential of aid, and hence maximize aid effectiveness. Stern et al. (2002) acknowledge that as a result of the shift to selectivity, ODA effectiveness tripled during the 1990s.

During the last decade, multilateral as well as bilateral donors have put more emphasis on aid allocation selectivity with respect not only to poverty, but also to GG in recipient countries. For example, the WB has been very vocal about concentrating its financial assistance on poor countries with sound development management (WB, 1998, 2000, 2002). While in 1995 the DAC stated that “participatory development and good governance must be central concerns in the allocation and design of development

assistance” (p.5), individual countries, such as Japan, Canada, Norway and Germany, had previously signalled their intentions and commitments in this regard. Others took longer to adhere, such as the Netherlands, which waited until 1998. More recently, the 2002 International Conference on Financing for Development reiterated, as part of the Monterrey Consensus, the importance of selecting countries with GG in order to reduce poverty and increase welfare. Following this conference, the United States also pledged its support (US\$5billions) for selectivity through the establishment of the Millennium Challenge Account.

While donors have increasingly acknowledged the importance of selectivity based on GG in order to increase aid effectiveness, the evidence has failed to demonstrate a uniform change in aid allocation practices in line with this discourse. Moreover, little importance has been given to potential changes in who would receive aid and in what proportion. The next section addresses these concerns.

## **4. GG in Practice**

### **4.1 Aid Allocation Determinants**

Scholars have been analyzing the determinants of aid allocation for over 30 years<sup>7</sup>. The inclusion of variables now considered part of governance in allocation regressions is not a novelty. Indeed, as far back as 1977, McKinlay and Little considered political stability and democracy as potential determinants of aid allocation. However, more recently, the GG agenda and the discourse on selectivity described earlier spurred a renewed interest

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<sup>7</sup> For a complete overview of multivariate regression studies on aid allocation determinants, see Neumayer (2003b:21-29).

in evaluating the relevance of such variables for aid allocation. While bearing in mind that the econometric tools utilized vary and that the dependent and explanatory variables included in different studies differ, the results have been rather mixed.

Indeed, while some researchers such as Poe et al. (1994) and Trumbull and Wall (1994) found a positive and significant relationship between aid allocation and civil and political rights for individual donors (United States) for the former, as well as for multilateral donors for the latter, a greater number of studies have found inconclusive or even negative results. For example, in a panel data analysis of the United States' allocation of aid, Payaslian (1996) could not prove that personal integrity and political and civil rights in recipient countries played a significant role. Hout (2002), focusing on the Netherlands' 2000 aid allocation, came to the same conclusion about a number of GG variables, although he gave partial support to the regulatory burden variable. Svensson (1999), looking at various donors, came to the conclusion that while the UK and 'like-minded countries' such as Canada, Holland and those of Scandinavia favour recipients with better political and civil rights, others do not take them into consideration at all and prefer to allocate money according to their own interests. Finally, a third group composed of countries such as France and Italy allocate more aid to their former colonies, which often have poor political and civil rights, resulting in a significant but negative relationship. Improving on Svensson's choice of explanatory variables, Alesina and Dollar (2000) found that most donor countries, apart from France, Italy, Belgium and Austria, do favour recipients with better political and civil rights. However, Alesina and Weder (2000) concluded that this result does not hold for another component of GG, corruption control.

In fact, they found that only Australia and Scandinavian donors utilize corruption control as a basis for selectivity. Svensson (2000) and Neumayer (2003a) also support the weak role of corruption control in choosing suitable recipient countries. The most recent and comprehensive study on the role of GG in aid allocation decisions is Neumayer's (2003b) treatise, *The Pattern of Aid Giving: The Impact of Good Governance on Development Assistance*. In this study of the major donors spanning the 1991-2000 time-frame, Neumayer finds that the majority of them do not use the GG criterion as a basis for selectivity. He concludes that his analyses of the eligibility and level stages have similar results and that "[n]o consistent picture emerges with respect to any one donor, or groups of donors or any one aspect of GG. Of all the aspects of GG, it seems that low regulatory burden is the one that plays the greatest role" (p.81).

As the above overview demonstrates, while many donor countries and multilateral agencies have recognized the importance of GG in recipient countries and selectivity based on this criterion in order to increase aid effectiveness, it has not been consistently put into practice. The following empirical analysis assesses the situation for 2001, the year the last year for which data on aid flows is available.

#### **4.2 GG and the 2001 Allocation of Aid:**

The purpose of the following econometric analysis is to determine whether donors have practiced selectivity based on GG in the 2001 aid allocation. The regression is a standard one, with aid disbursed as the dependent variable, and explanatory variables capturing recipient needs, donor interests, and of course, the quality of governance.



#### ***4.2.1 Dependent Variable:***

##### *4.2.1.1 ODA or EDA?*

Most studies on aid allocation have used total net ODA<sup>8</sup>, recorded by the OECD, as the basis for a dependent variable. However, Chang et al. (1998) have developed a new way of calculating aid flows based on the WB's Debtor Reporting System, which overcomes some of the shortcomings of ODA (mainly those related to the difference between loans and grants) and referred to as Effective Development Assistance (EDA). EDA is defined as "the sum of the grant equivalents of all development flows disbursed in a given period" (p.6). While EDA may be a more accurate way of measuring aid flows, the following regression uses ODA data. This is mainly due to the fact that EDA was only calculated until 1995. The novelty about the following empirical analysis is that it evaluates the most recent available data on aid flows; using EDA would therefore defeat its purpose. Moreover, Chang et al. (1998) themselves acknowledge that the correlation between the two measures is quite high<sup>9</sup>, thereby minimizing the concerns about using ODA instead of EDA.

##### *4.2.1.2 Emergency and Technical Assistance*

A further note about the dependent variable concerns the exclusion of emergency and technical assistance. The first component of aid, representing about 5.5% of total transfers in 2001<sup>10</sup>, should not be taken into consideration when examining the

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<sup>8</sup> Total net ODA is measured by total disbursements minus amortization (OECD, 2003).

<sup>9</sup> Chang et al. (1998:10) found a 0.89 correlation coefficient between ODA and EDA for their whole sample on a nominal basis, and 0.93 for three-year moving averages.

<sup>10</sup> Percentage arrived at from author's calculations, based on data from OECD (2003) and *International Development Statistics online*.

significance of GG in allocation choices. This is because emergency assistance, as its name indicates, is provided in response to emergencies, and should therefore be given regardless of the quality of governance. If this component was kept in the analysis, the results could be negatively biased (GG variables would appear less significant than they actually are). In order to avoid such bias, emergency assistance is subtracted from total net ODA. The same logic follows for the treatment of technical assistance. However, disaggregated ODA data for 2001 is not available for this particular type of aid and is therefore not removed. When looking at the results, one has to keep in mind that there could be a slight negative bias because of the inclusion of technical assistance. Data for the dependent variable, total net ODA minus emergency assistance, are taken from the OECD (2003) and *International Development Statistics online*.

#### ***4.2.2 Explanatory Variables:***

Following mainstream aid allocation equations, the variable capturing recipient needs is income, and is measured by the gross domestic product (GDP) per capita taken from *International Development Statistics online*. Donor interest variables include a variable of arms imports as a proportion of total imports to capture military interests, a dummy variable for former colonies (since 1900) of OECD countries and regional dummy variables. Data on arms imports are taken from the WB's *World Development Indicators*, while the CIA's *World Fact Book* is the source for the colonial dummy. A population variable, taken from the WB's *World Development Indicators*, is also included to determine whether more populous countries receive more aid.

Finally, GG variables are also included in the aid allocation equation to verify if GG is actually used as a basis for selectivity. There exist many different sources of indicators capturing different aspects of governance. Some are very expensive to obtain and, more importantly, only cover a limited number of LDCs, which could bias the results. For the purposes of this paper, a broader governance index representing all components of GG is used. The GG indices elaborated by Kaufmann, Kraay and Zoido-Lobato (1999a,b, 2002), henceforth referred to as the KKZL indices, are well suited since they incorporate 31 different indicators from 17 sources into 6 clusters and cover a more voluminous set of countries, thereby minimizing the risk of sample bias. When crossing the country data available for ODA, other independent variables and GG indicators updated for 2000/2001, a total of 100 developing countries are included in the sample<sup>11</sup>. It should be noted that KKZL indices are constructed from *aggregated subjective data*, and therefore have a somewhat important standard deviation. However, as the authors (1999a:27) point out, “they are also much more reliable than any individual indicator”.

The six clusters identified in the KKZL measure are the following (this description is mainly taken from KKZL (2002)):

- 1. Voice and Accountability:** measures the political process, civil liberties and political rights, as well as the independence of the media and the extent to which citizens are able to participate in the selection of governments.
- 2. Political Stability and Violence:** measures the perception of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means.

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<sup>11</sup> Annex 1 presents the full list of countries included in the sample.

3. **Government Effectiveness:** measures the perception of the quality of public service provision and of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressure, and the credibility of the government vis-à-vis commitment to its policies.
4. **Regulatory Quality:** is more focused on the policies themselves, and therefore responds to some degree to the ‘good policy’ prescription. It includes measures of the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, as well as perceptions of the burdens imposed by excessive regulation in areas such as foreign trade and business.
5. **Rule of Law:** measures the extent to which agents have confidence in and abide by the rules of society. It includes perceptions of the incidence of both violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.
6. **Control of Corruption (Graft):** measures the perception of corruption, the effect of corruption on the business environment, and incidence of grand corruption in the political arena and state capture.

Following Neumayer (2003b), the dependent variable was logged so as to make its distribution less skewed. Moreover, in order to interpret the coefficients for population, income and arms imports as elasticities, these variables were also logged. Elasticities are useful in order to interpret the results since they inform on the percent change in the dependent variable due to a 1% change in the explanatory variable. Transforming the governance variables in the same way makes less sense since it is not clear what a 1% increase in the political stability rating, for example, implies.

### ***4.2.3 Results***

The results are presented in Table 1. Column (1) reports the results for a base regression, which does not include any GG variables. It shows that more populous and poorer countries receive more aid. This makes sense since the aim of ODA is to increase economic growth and welfare and that bigger countries need more funds than smaller ones. As for donor interest variables, most of them are insignificant. This can be explained by the fact that aggregated (bilateral and multilateral) aid is dealt with here; thereby minimizing the importance of donor interests variables which are mainly associated with bilateral donors. One can however note that European recipients are favoured by aid donors, while Middle Eastern countries receive opposite treatment. The first observation implies that close geographic proximity to important European donors is an asset to recipient countries, while the second observation leads to believe that countries with important wealth, such as valuable exploitable natural resources, are discriminated against.

Results of a regression combining all GG indicators are shown in Column (2). According to this regression, it seems that only the regulatory quality of recipient countries matters to donors. Donors are therefore concerned with the incidence of market-unfriendly policies in recipient countries, which translates some of the concerns of the 'good policy' debate. However, other components of GG are ignored by donors.

**Table 1: OLS regressions: Determinants of Aid Allocation, 2001.**

Dependent variable: log (ODA-Emergency relief)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Base	All GG Variables	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
Log population	0.542*	0.397*	0.549*	0.546*	0.534*	0.525*	0.546*	0.545*
Log GDP/Capita	-0.410*	-0.564*	-0.450*	-0.445*	-0.548*	-0.556*	-0.522*	-0.428*
Arms imports	0.021	-0.131	0.029	0.023	0.033	0.039	0.027	0.023
Colonies	0.043	-0.628	0.026	0.061	-0.037	-0.104	0.035	0.030
Africa	-0.497	-0.264	-0.557	-0.508	-0.731	-0.741	-0.744	-0.559
America (South, Caribbean, Central)	-0.153	-0.629	-0.187	-0.139	-0.077	-0.315	-0.033	-0.154
Europe	1.039*	1.114*	0.989*	1.078*	1.112*	1.052*	1.076*	1.036*
Middle East	-1.98*	-2.103*	-1.936*	-1.997*	-2.077*	-2.025*	-2.016*	-1.986*
Voice and accountability		-0.033	0.149					
Political stability		-0.070		0.099				
Government effectiveness		0.291			0.322			
Regulatory quality		<b>0.472*</b>				<b>0.446*</b>		
Rule of law		-0.022					0.285	
Control of corruption		-0.289						0.0598
Adjusted R-squared	0.612	0.627	0.612	0.610	0.621	0.639	0.6179	0.608

\* Significant at the 5% level (2-tails test).

Note: the constant is not reported in the above table.

Columns (3) to (8) report regression results for each of the GG clusters assessed individually. This was done in order to avoid potential multicollinearity among GG variables that could bias the results of Column (2). In all regressions, the conclusions for the base regression are maintained. In analysing the determinants of the 2001 aid allocation only, endogeneity concerns regarding the dependent and GG variables are minimized. It should be considered that governance characteristics change slowly over time, and that it is highly unlikely that aid allocated in 2001 could have had an impact on the level of governance of 2000/2001. Looking at the explanatory power of the different regressions, one can conclude that regression (6), which includes Regulatory Quality on the right-hand side, is the most appropriate since the R-squared is the highest. Since none

of the other components of GG are significant whether combined in a regression or included individually, these regressions also clearly show that in 2001, Regulatory Quality was the only aspect of GG taken into consideration by donors when allocating aid funds. This result is in line with Svensson (2002) and Neumayeur (2003b), who also found some support for 'regulatory burden' as a determinant of aid allocation. However, this finding does not yield strong support for the 'selectivity based on GG' premise of donors.

In light of this analysis, a relevant question is: What is the weight of Regulatory Quality in allocation decisions? Moreover, how would the allocation of ODA differ if the GG criterion, regulatory quality, weighted more in the decision-making process? Which countries would win, and which ones would lose, if donors paid even more attention to price controls and excessive regulation in the economy of recipients? The next section canvases this.

#### **4.3 Simulation of Changes in the Allocation of Aid Due to Increased Weight of GG Criteria in Decision-Making.**

The results discussed above support the conclusion that in 2001, apart from population size, level of poverty and two regional dummies, donors only relied on the incidence of market-unfriendly policies to decide whether a country should receive more or less ODA. This finding does tell that other GG variables are not significant, but it does not however inform on the weight of each of the significant variables in the decision-making process. By verifying how much of a change in one standard variation in all significant variables is explained by each variable, it can give an approximate idea of the role played by each.

This exercise shows that 44% of the total change is explained by the population size, 38% by the level of poverty, and only 18% by regulatory quality. These results show that, not only is regulatory quality the only component of GG involved in allocation decisions, but it is also the least important of the factors explaining allocation decisions. Once again, one can conclude that the donors' discourse on selectivity based on GG is only weakly demonstrated in practice.

If, in 2001, donors had actually acted as they said they should, and put more emphasis on GG as a basis for selectivity, the allocation of aid would therefore have been altered. While this new allocation may increase aid effectiveness, it also engenders winners and losers. In order to assess who would win and lose from such a change, a WB simulation tool elaborated by Vaillancourt and Vaillancourt (2001) is used to reallocate ODA while changing the weights of population, poverty and governance in the decision-making process.

While many simulations with different weights were performed, the preferred simulation is the one allocating the following weights to the three variables of interest: population size (25%), poverty (25%) and governance variable –regulatory quality- (50%). By allocating more weight to governance, the selectivity premise is respected. However, it is important to be realistic and also take the other two variables in consideration. With these weights, countries with better regulatory quality, which are poorer and more populous, will receive more ODA. Tables 2 to 5 report the results of the 2001 reallocation of ODA (minus emergency assistance) considering the reviewed weights.



**Table 2: Analysis by Population**

	<b>% Total Population</b>		<b>% Total Population</b>
<b>10 Biggest Winners</b>	0.86	<b>All Winners</b>	71.19
<b>10 Biggest Losers</b>	8.29	<b>All Losers</b>	28.81

**Table 3: Analysis by Quintiles of GDP per Capita**

<b>Quintiles</b>	<b>% ODA Change</b>	<b>% Total Population</b>	<b>GDP/Capita (\$US)</b>	<b>Average Reg. Quality</b>
1	-48.20	7.26	185.18	2.02
2	-10.26	36.45	432.58	2.07
3	9.22	36.91	886.73	2.07
4	4.53	13.94	2179.60	2.56
5	369.11	5.44	5943.87	2.96

Table 2 presents the results in terms of percentage of the total sample population. It shows that, although the ten biggest losers include a greater proportion of the total population than the ten biggest winners, the overall winners comprise 71% of the entire sample population. This seems to be good news. Indeed, if donors can, by being more selective on the bases of governance, increase aid levels to the majority of people, such selectivity is a good idea. A note of caution on the negative relationship between wealth and governance (regulatory quality) is however necessary. Although causality concerns are not addressed here, Table 3 demonstrates that poorer countries, those in the first and second quintiles of GDP per capita, are the ones with the lowest governance scores and are losers. On the other hand, the richest quintile, representing a mere 5.5% of the total sample population, has the highest governance score and would see their aid level increase by 369%. This means that even though the majority of people would see the level of ODA given to their country increase, those penalized are the poorest ones.

**Table 4: Analysis by Regions**

<b>Regions (% of total sample)</b>	<b>% ODA Change</b>	<b>% Total Population</b>	<b>GDP/Capita (\$US)</b>	<b>Average Reg. Quality</b>
Africa (39%)	-34.02	16.73	663.96	2.19
America (23%)	40.88	10.92	3684.19	2.74
Europe (7%)	-13.13	0.44	2782.75	2.26
Middle East (7%)	69.57	2.47	3244.29	2.58
Asia (22%)	17.54	69.32	749.09	2.14
Oceania (2%)	37.09	0.13	764.93	2.11

**Table 5: Ten Biggest Winners and Losers**

<b>Winners</b>	<b>% ODA Change</b>	<b>Population</b>	<b>GDP/capita (\$US)</b>	<b>Regulatory Quality</b>
COSTA RICA	16113.60	3873000	4159.11	3.38
OMAN	13995.60	2478000	8000.71	3.10
MALTA	11515.74	395000	9172.00	2.83
GABON	1870.51	1260790	3437.22	2.38
URUGUAY	1509.77	3361000	5553.82	3.45
BAHRAIN	1179.25	651000	12189.02	3.28
MALAYSIA	892.67	23802360	3698.82	2.72
BELIZE	879.02	247110	3257.66	2.83
MAURITIUS	848.55	1200000	3750.27	2.91
PANAMA	775.06	2897000	3510.80	3.41
<i>Sample Average</i>		<i>46590087</i>	<i>1818.30</i>	<i>2.34</i>

<b>Losers</b>	<b>% ODA Change</b>	<b>Population</b>	<b>GDP/capita (\$US)</b>	<b>Regulatory Quality</b>
LAOS	-64.21	5403170	325.86	0.96
PAKISTAN	-65.45	141450100	414.76	2.12
BOLIVIA	-65.49	8515220	935.88	3.16
EGYPT	-67.66	65176940	1510.90	2.63
UGANDA	-68.67	22788000	249.05	2.30
VIETNAM	-70.21	79526050	411.47	2.00
MOZAMBIQUE	-70.75	18071160	199.59	2.66
HONDURAS	-71.86	6584730	969.79	2.34
TANZANIA	-75.30	34449620	271.14	2.48
BOSNIA-HERZEGOVINA	-81.04	4060000	1174.66	1.32
<i>Sample Average</i>		<i>46590087</i>	<i>1818.30</i>	<i>2.34</i>

A regional decomposition of ODA changes is also informative, as is shown in Table 4. Indeed, increasing regulatory quality's weight in allocation decision, while reducing the importance given to population and poverty, results in a 34% decrease in aid flows to the African continent, which is considered to be the region in most dire need of aid. The negative change associated with Europe is probably due to the positive bias found in the 2001 aid regression, while the increase in the Middle East's share due to the negative bias, as well as to its higher regulatory quality score (see Table 1). Once again, the basic conclusion is confirmed: donors would mainly be favouring countries enjoying higher GDP per capita.

Table 5 lists the ten biggest winners and losers from the simulated reallocation. One can notice that the winners experience a much greater percentage increase in ODA than the losers experience a decrease. This could be interpreted as a sign that many of the winners were not receiving large amounts of aid in the original distribution, probably due to their high levels of GDP per capita. However, by allowing the governance criteria to weight more in the allocation decision, these countries are favoured by the donor community and rewarded as such. For example, in the original 2001 ODA distribution, Oman and Costa Rica each received a tiny 0.005% of total ODA disbursed, while the reallocation spurred their earnings to 0.68% and 0.76% respectively. The trade-off between giving more importance to governance while diminishing the importance of wealth and population may be too expensive. While the regulatory quality scores of the ten biggest winners are all above the sample average, those of the ten biggest losers vary widely. In fact, only five of them are below the sample average. This leads to the conclusion that while the

selectivity premise aims at penalizing recipients with poor governance scores, it is not actually the countries with the lowest governance scores which lose the most.

The donor community has to reflect on these observations and decide if, in order to increase aid effectiveness, it is willing to sacrifice aid transfers to the poorest countries. Some, as Bräutigam (2000), point to the fact that the emergence of selectivity is actually a response to the reality that the poor were not benefiting from ODA in the first place. However, even if in countries with low governance scores the actual amount of ODA used for developmental purposes is far from a one-to-one ratio, the population may still have benefited from a small portion of it. If donors limit their aid flows to these countries, their population will see this slight portion of hope diminish even more.

One avenue to consider in trying to help these people while still performing selectivity, is to re-orient the surplus of aid allocated to richer countries with GG. Indeed, such countries (Bahrain, Malta and Oman for example) are in lesser need of ODA since foreign direct investment flow in greater quantity to countries with a suitable environment for investment. Instead of favouring these countries, the surplus of aid could be reallocated to poor countries with GG scores above average (such as Bolivia and Mozambique) or to poor countries with lower scores, but demonstrating a strong willingness to change. Instead of giving them aid in cash, money could be used to provide technical assistance and build state capacity (Neumayer, 2003b), which will eventually lead to better governance, greater aid efficiency and greater potential for growth and development. However, the case of badly governed poor countries (such as Laos) remains a problem.

Indeed, the only solutions proposed can only be temporary. For example, giving emergency assistance may relieve temporary shortages of food and other resources, but will not foster long term development. Another option suggested by many is to channel money through non-governmental organizations instead of going through the government. While this can be an ideal short term solution, in the long term, cooperation problems between different organizations may arise, leading to poor targeting and efficiency. Moreover, going around the government does not create any incentives for the latter to better the institutions and the quality of its services (Thomas, 1992). Indeed, if someone else is taking care of its people, why should a government make efforts to become better at it?

Increased selectivity of donors can be a great tool to provide incentives to poor countries with bad governance in the present, but having a determination to change. As demonstrated by the simulation, it however penalizes some countries with above average governance scores. For those unwilling to compromise and cooperate, increased selectivity only means that even less money will reach these people suffering from poverty. The solution to the latter problem is one that has yet to be solved.

## **5. Conclusion**

This paper is based on the widely acknowledged premise that developing countries need external financial assistance to develop, increase economic growth and welfare. These are actually the main goals of ODA, as expressed by the OECD's DAC. While these goals are righteous, ODA's effectiveness in reaching them has so far been disappointing.

The first part of the paper demonstrated that, although empirical evidence now refutes the micro-macro paradox and mainly shows the existence of a positive relationship between aid and growth, it is believed that the strength of this relationship can still be improved. Researchers have now turned to omitted variables, the quality of macroeconomic policies and of governance in recipient countries, in order to explain the poor performance of aid. The second part of the paper traced the emergence of the good governance agenda: from the deceiving development outcomes under economic policy-based conditionality, to the shift in development thinking in the 1990s which acknowledged the important role of the state in establishing the appropriate environment for the liberal market to function, to the empirical evidence supporting the link between GG and developmental outcomes, and finally to the shift in foreign aid allocation policy away from political conditionality to an increasing focus on selectivity based GG.

The third section of the paper focused on the practice of the selectivity principle in aid allocation. It showed that, while the donor community has increasingly voiced its support for selectivity, its actions have not been in consequence. An econometric analysis of the 2001 aid allocation, the last year for which ODA data is available, supported the fact that donors have not used most aspects of GG as a basis for selectivity. In fact, only one of the six KKZL's governance indicators, regulatory quality, was statistically significant. Finally an aid reallocation simulation, according more weight to regulatory quality was performed. Its purpose was to quantify the changes in aid disbursements to recipient countries according to the hypothesis of an increased practiced of selectivity by the

donors. This simulation uncovered a significant change in aid flows, mainly favouring richer countries and leaving many poorer ones, some with GG scores above average, behind.

While the idea of selectivity based on GG has emerged as a way to create incentives to stimulate GG in countries lacking it, to overcome the meagre performance of aid and the failure of political conditionality, the donor community has to reflect on the consequences of such an endeavour. Is giving more money to richer countries the answer? Instead, the surplus of money allocated to richer developing countries with good governance should be replaced by direct foreign investments. The money hence saved should be reinvested in the poor countries with good governance, or lower governance but demonstrating a strong willingness to change. The challenge for development practitioners lies in finding a way to help people in poor countries without good governance or willingness to change, while still creating the right incentives to foster the development of good governance.

**ANNEX 1: List of Countries Included in Sample**

<b>Africa</b>	<b>America</b>	<b>Europe</b>	<b>Middle East</b>	<b>Asia</b>	<b>Oceania</b>
ALGERIA	ARGENTINA	ALBANIA	BAHRAIN	ARMENIA	FIJI
ANGOLA	BELIZE	BOSNIA- HERZEGOVINA	IRAN	AZERBAIJAN	PAPUA NEW GUINEA
BOTSWANA	BOLIVIA	CROATIA	JORDAN	BANGLADESH	
BURKINA FASO	BRAZIL	MACEDONIA	LEBANON	CAMBODIA	
BURUNDI	CHILE	MALTA	OMAN	CHINA	
CAMEROON	COLOMBIA	MOLDOVA	SAUDI ARABIA	INDIA	
CONGO	COSTA RICA	SLOVENIA	SYRIA	INDONESIA	
IVORY COAST	DOMINICAN REPUBLIC			KAZAKHSTAN	
EGYPT	ECUADOR			KYRGYZ	
ETHIOPIA	EL SALVADOR			REPUBLIC	
GABON	GUATEMALA			LAOS	
GAMBIA	GUINEA			MALAYSIA	
GEORGIA	GUYANA			MONGOLIA	
GHANA	HAITI			NEPAL	
GUINEA-BISSAU	HONDURAS			PAKISTAN	
KENYA	JAMAICA			PHILIPPINES	
LIBERIA	MEXICO			SRI LANKA	
MADAGASCAR	PANAMA			TAJIKISTAN	
MALAWI	PARAGUAY			THAILAND	
MALI	PERU			TURKEY	
MAURITANIA	SURINAME			TURKMENISTAN	
MAURITIUS	URUGUAY			UZBEKISTAN	
MOROCCO	VENEZUELA			VIETNAM	
MOZAMBIQUE					
NAMIBIA					
NIGER					
NIGERIA					
SENEGAL					
SIERRA LEONE					
SOUTH AFRICA					
SUDAN					
TANZANIA					
TOGO					
TUNISIA					
UGANDA					
YEMEN					
Congo, Dem. Rep. (Zaire)					
ZAMBIA					
ZIMBABWE					



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