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Development Economics and The International Development Association

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Abstract

Prevailing economic ideas—and fashions—about development have influenced the International Development Association (IDA) since its creation in 1960. The creation of the organization itself is the result of two contemporaneous facts: an urgent need to channel development finance to least-developed countries and an increasing pressure on World Bank management to directly address the issue of poverty in developing countries. Changing views, over time, have been a rationale—and, at times, a justification—for emphasizing poverty and social sectors; for providing grants to particular groups of countries; and for strategic choices and sectoral priorities. IDA has been influential in development debates and been an advocate for specific views about development policy. This paper gives an overview of these views and documents how they have shaped the activities of the organization since its creation. After a brief review of development thinking and of the organization of research at the World Bank, the paper documents the shifts that have taken place in country allocations and in sector emphasis in IDA over the past 50 years and highlights the strategic themes that have guided its development agenda: toward increasing country selectivity; from projects to programs; from conditionality to country ownership of reforms; and from input-based to results-based performance.

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DEVELOPMENT ECONOMICS
AND
THE INTERNATIONAL DEVELOPMENT ASSOCIATION

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Introduction

The report *IDA in Retrospect*, which was published on the occasion of the 20th anniversary of the institution, makes the point that "IDA's influence on policy reform, on creating viable development institutions, and on general economic and sector analysis is perhaps its most important contribution to development in member countries" (World Bank 1982, p. 11). The contribution of the International Development Association (IDA) to the external and internal accounts of poor countries has always been modest, since it has never exceeded 2 percent of total investment, but its influence is much broader. It is therefore useful to examine prevailing ideas about development and the influence they have had on IDA since its creation in 1960. Prevailing economic views have influenced IDA and provided a rationale—and even, at times, a justification—for how loans are extended to developing countries; for the sectors to which they are directed; and for the emphasis placed on poverty and social sectors.

A multitude of factors—political, economic and ideological developments in developing and donor countries—have influenced the development of IDA and economic ideas have also been a major influence. John Maynard Keynes once said that "practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist," and, in the case of IDA, this has been true of all economists, defunct or alive. Their views have, at times, had a significant influence on country allocations and sector emphasis as well as on IDA's business model in general. Moreover IDA—as well as the International Bank for Reconstruction and Development (IBRD)—provides many opportunities for learning about development, and their operations have been an important source of empirical validation for development theory and have influenced the direction taken by this field of knowledge.

Thus the World Bank—because of its ability to learn from its projects and policies and because it has nurtured a cadre of good researchers—has been a major contributor to development economics through research studies, the collection and dissemination of data, and cooperation between researchers and operational staff. Given the close connections between IDA and development economics, it is appropriate to sketch their parallel history and to understand the main interactions.

The World Bank and the Emergence of the "Developing World"

The creation of the International Development Association in 1960 was the result of two parallel developments: the need to channel funds to the most underdeveloped countries of the periphery, some of which had become newly independent, and the increasing pressure on World Bank management from a burgeoning aid community in rich countries to address the issue of widespread poverty.

Until then, the management of the World Bank had narrow views about what it should finance and its freedom of action, in any case, was limited by the strictures of Wall Street. It chose to finance only so-called productive sectors and to stay away from projects that might favor the rural or urban poor.[2] These management views were reinforced by an almost universal belief among development economists—from Hans Singer to Arthur Lewis to Raul Prebisch—that development was synonymous with industrialization and urbanization and that the bulk of investment should go toward non-agricultural activities.[3]

The World Bank in its early years—in other words, the International Bank for Reconstruction and Development—having been undercut by the Marshall Plan (announced in June 1947) to finance the reconstruction of Europe, shifted its focus to "development loans." The definition of what constituted "development" was narrow and included only productive activities such as industry, mining, shipping and transport, and public works. Top management was concerned about establishing the Bank's reputation on Wall Street and the rating of its bonds, and followed conservative financial policies. It rejected the idea of "social" loans for activities such as housing, education or even water supply to households.[4] The first loan to Latin America was made in March 1947 (to Chile) and to Asia in August 1948 (to India).

Throughout the 1950s and part of the 1960s, the Bank "turned a deaf ear to the steady demands from borrowers and the burgeoning aid community for a softer attitude to social needs." [5] However a certain schizophrenia developed in the Bank. While on the one hand, the Bank chose "to be occupied with the need to meet exacting standards for

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[2] This is documented in several sources, in particular Kapur, Lewis and Webb (1997) and Alacevich (2009)
[3] Kapur, Lewis and Webb (1997), pp. 114-120.
[4] Alacevich (2009) gives specific examples for Colombia
[5] Kapur, Lewis, and Webb (1997), p. 142

each of its projects,"[6] it was also carrying out broad assessments of its client countries' needs—some of which stressed the extent of poverty and the vast social needs—to influence the borrower's development policies and practices. Although it fully recognized in its studies the need for education, health and social policies to address widespread poverty, it insisted on selecting only industry and infrastructure, and not social sectors, for its lending activities—essentially arguing that these were not productive activities that could directly contribute to the repayment of the loan.

"Survey missions" carried out by the Bank's operational staff analyzed the policies and practices of underdeveloped countries and made policy recommendations of a general nature. These missions produced reports similar to what is now called Economic and Sector Work. For example, in July 1951, the Bank made public recommendations on the economic development of Guatemala and countless other missions took place during the 1950s.

By contrast, economic analysis was limited to the conduct of financial feasibility studies for proposed projects, and research staff was left out of operations altogether, particularly since President Eugene Black is said to have paid little attention to their economic reports. Internal conflicts between operations (that is, lending and economic and sector work) and research arose almost as soon as the institution was created. At that time, Paul Rosenstein-Rodan—one of the founders of development economics—was Assistant Director of the Economics Department. He argued that it is useless for the Bank to be preoccupied with creditworthiness and individual projects. It should calculate the aid necessary to sustain a desired growth rate calculated from an assumed capital-output ratio and make massive loans on a continuing basis. This advice seemed like nonsense to bankers and lawyers in the Bank. Rosenstein-Rodan lost the battle and retreated to the Massachusetts Institute of Technology (where Max Millikan and Walt Rostow worked), where his influence expanded greatly: he became an adviser to the Alliance for Progress, to the governments of India, Italy, Chile, and the United States and later to Presidents of the World Bank since that time. Many of his ideas eventually came to be accepted in the Bank, but not for some time.[7]

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[6] Ibid, p. 125

[7] See Oliver (1975)

The economics profession was not particularly interested in development at the time—reflecting the lack of interest of people in metropolitan countries in this issue. Interestingly, all the "founding fathers" of development economics—including Rosenstein-Rodan, Lewis, Singer, Hirschmann, Myrdal, Nurske and Prebisch—worked for international organizations like the League of Nations, the United Nations or the World Bank. They strongly believed in the importance of industrialization. From World War II until the creation of IDA, development economics was a discipline in the making. It was empirically thin and the articulation of theories was at an early stage.[8] The idea of development was synonymous with aggregate growth and industrialization. Social considerations and the reduction of poverty were singularly absent from the discussions about development. The Australian economist H.W. Arndt, one of the best historians of the concept, in his book on *Economic Development. The History of an Idea* (1987) devotes separate chapters to the period 1945-1965 (the chapter is called "Development as Growth") and 1965-1975 ("Social Objectives").

Development was equated with growth, and growth was conceived simply as an accumulation process as in the Harrod-Domar model and later in the Solow model.[9] Both models focus on the savings rate and capital-output ratio ($v = K/Y$) as determinants of the growth rate. Solow's influential model was built around an aggregate production function assumed to produce a single good, Y. The model showed that the long-run growth rate of output, s/v, will come into equality with the natural growth rate of the labor force, n, through adjustment of the capital-output ratio, v. Increasing the savings rate will increase the growth rate in the short run but not the long run because v rises to bring growth back to the labor force growth rate n. A higher saving rate s will lead to higher long-run output per capita (at least if we ignore the problem of excess saving connected with s being permanently above the "golden rule" level). But in these models long-run growth of output per capita is possible only if there is technological progress. If that progress is labor-augmenting (that is, if it acts on output in a manner analogous to an expansion of labor input) at rate a, then it allows long-run growth with $s/v = a + n$ and output per capita

[8] See Meier (2005).
[9] See Stern, Dethier and Rogers (2005). Harrod (1939) and Domar (1946) were the first to highlight the importance of capital accumulation. Solow (1956) developed a more sophisticated model of the growth process, soon followed by Cass (1965) and many others.

growing at rate a. Many development scholars since then have expressed qualms about using an aggregate production function with a single good to describe the accumulation and technological progress underlying a growth process. Its immediate implications include that technological progress is divorced from capital accumulation, higher savings does not increase the long-run growth rate, and learning does not occur. Arrow (1962) provided a seminal analysis of the economic implications of learning by doing but his model had no influence on practical thinking in the development community.[10]

The Harrod-Domar and Solow models may have been useful organizing frameworks for asking questions about savings and capital accumulation in rich countries dominated by a service sector with lower fixed capital requirements and fairly flexible factor markets. But these models are questionable for developing countries. Even endogenous growth models that focus on learning and returns to scale have almost nothing to say about structural change and changing behavior—or about institutions, governance, and policies, and how poor institutional and governance structures hobble the markets for factors, goods, and services—which are issues that are at the core of the "urgent problem of economic development."[11]

Arthur Lewis published in 1954 what has probably became the most influential article on development economics, thus inaugurating the dualistic view of development in which a traditional and backward sector (agriculture, presumably) can provide an infinite supply of labor at a given wage to an incipient modern industrial sector without affecting productivity. It represents a step toward a better understanding of the development process. But the empirical validity of his assumption has been questioned by Rosenzweig (1988) who shows that, even in densely populated economies, labor supply curves are upward sloping.

All major thinkers, including Lewis, Prebisch and Singer, believed in the need for industrialization and dismissed the importance of investment in the agriculture sector,

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[10] Arrow's model can produce steady-state growth with no exogenous technical progress. Formally, this looks similar to the steady growth rate in an ordinary neoclassical model embodying some increasing returns. This particular feature, where learning causes the benefits of investment in human capital to act like an externality, characterizes the "new growth theories" (also known as endogenous growth theories) that emerged in the late 1980s (see Romer 1986, Lucas 1988, Aghion and Howitt 1992).

[11] The World Economic Report 1948 of the United Nations mentions the need to do something about the "urgent problem of economic development of underdeveloped countries." (cited in Arndt, 1987, p. 49).

which was considered backward. During the 1950s, the intellectual discussions opposed the partisans of balanced and unbalanced growth, but no-one questioned the primacy of industry. [12]

Although the primacy of investment and industrialization was widely accepted, Prebisch (1962) and the Latin American CEPAL school opted for import substituting industrialization (ISI), behind high barriers to trade, because of their "export-elasticity pessimism," which largely amounted to the view that, since terms of trade for primary products were declining, longer term growth could not be expected from the dependence on primary commodity exports.[13] Countries had to develop the manufacturing sector to meet domestic demand and, where possible, generate revenues from exports to earn enough foreign exchange.[14] By contrast, Asian economies, which developed a national vision of development in the 1950 (essentially, South Korea in the aftermath of its war with the communist North), championed the advantages of export-oriented industrialization. Both export oriented and import substituting types of countries, however, were strongly devoted to a *dirigiste* approach to development complete with five-year plans and an array of tax incentives, subsidies, exchange rate policies, tariffs and directed credit to help new industries germinate and grow a generation of public and private entrepreneurs.

The views about developing countries during the 1950s were optimistic—with a rather touching belief in the possibility to achieve rapid development, especially with outside intervention—but also patronizing. For instance the World Bank 1951 report on Guatemala mentioned above states that one obstacle to development is the "cultural

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[12] Rosenstein-Rodan (1943) argued for a "Big Push" of investment led-growth which would enable an economy to loosen multiple constraints, realize scale economies and generate the needed demand. Gerschenkron (1962) showed that economic backwardness could be turned to the advantage of late starters by means of institutional innovations that enabled them to surmount barriers and exploit the potential inherent in catching-up. Nurkse (1959) visualized "balanced growth", i.e., a mutually supporting advance across a broad range of sectors, through a coordinated investment strategy that would propel the economy out of poverty. Hirschman (1958) pleaded for "unbalanced growth", maintaining that leading sectors should emerge which would stimulate the rest of the economy with the help of profitable forward and backward linkages (see Yusuf 2008).

[13] CEPAL is the Spanish acronym for the United Nations Economic Commission for Latin America and the Caribbean.

[14] Coatsworth and Williamson (2002) show that from the middle of the nineteenth century, Latin American governments had begun relying on tariffs to generate revenues and protect special interests. The import barriers erected after the First World War to develop industry were thus an outgrowth of past policies.

isolation and the defensive attitude of the Indians," and similar reports on Ceylon state that it is the caste system and the "conservative pressure of religious forces," and on Jamaica, "a lack of energy and cooperation."[15]

Assar Lindbeck summarized economic thinking about developing countries in the late 1950s as follows.[16] "The dominant vision among economists with regard to the basic mechanisms of the development process changed considerably during the course of the post-World War II period. The main visions during the 1940s, 1950s and early 1960s have usually been characterized as structuralist—ideas tied to names like Paul Rosenstein-Rodan, Ragnar Nurkse, Raul Prebisch, Hans Singer and Gunnar Myrdal. The term 'structuralist' then refers to the notion that the developing countries are characterized by genuine inflexibility in the allocation of resources, due to inelasticities of supply and demand for goods, services and factors, as well as of productive effort in response to changes in economic incentives, such as relative price signals. Based on this vision of the development process was the idea of binding constraints on economic growth, like the "two-gap" theory of a savings and balance-of-payments constraint, due to asserted weaknesses in the response of saving to changes in income and interest rates, and of exports, imports and long-term capital movements to changes in exchange rates, relative prices and rates of return on productive assets. From these views followed both a strong distrust of the price mechanism, and as a mirror image, considerable enthusiasm for comprehensive central planning of inputs, outputs and investment activity.

"Recommendations were prevalent regarding public regulations and interventions to increase public saving and investment, the latter often in the form of large-scale projects in basic industries in order to deal with indivisibilities and externalities. Heavy protection, via direct controls (i.e., licensing) and high tariff barriers were other important components of the package of policy recommendations. Although some of these policies could certainly be well defended in the early post-World War II period, many governments were not flexible enough to shift to more decentralized and less interventionist policies when the usefulness of the previous approaches eroded."

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[15] Kapur, Lewis and Webb (1997), p. 146.
[16] This quote is taken from an evaluation of World Bank research carried out by Lindbeck (1984).

The 1960s are considered to be the "golden age" of capitalism, both for industrialized countries, which were finally emerging from the post-war period, and for developing countries—all of which (with a few exceptions, such as Argentina) were starting from a very low base.[17] At no time in past centuries had the world economy achieved such a rate of growth and at no time in the past had the leading industrialized economies and a few industrializing ones expanded at such spectacular rates for almost two decades. Countries such as Ghana, Kenya, Pakistan, Malaysia and the Philippines and many others began registering respectable growth rates as new manufacturing industries came on stream, and the Green Revolution in agriculture increased yields. The countries that did not grow were victims of extreme predation by dictatorial regimes; civil unrest, which stifled economic activity; or extraordinary incompetence on the part of inexperienced and rapacious ruling elites.[18] In spite of protectionism, wrong-headed trade and exchange rate policies, strong bias against agriculture and in favor of industry, white elephant projects and wide-spread corruption (think Mobutu or Marcos)—nothing could stop growth in the developing world.

The mainstream view about the constraints faced by developing countries was codified by two economists who would later become Chief Economists at the World Bank, Hollis Chenery and Michael Bruno.[19] The two-gap model formalized and linked the domestic and foreign resource needs since it was apparent that growth of developing countries was constrained not only by the scarcity of domestic capital, but also by foreign exchange to finance purchases of capital goods and other needed intermediate and consumption goods. Many economists interested in development tried (somewhat ineffectually) to identify instruments for enhancing saving propensities in order to close the gap between a desired investment rate and the rate of domestic savings.

Throughout the 1960s, development economics helped to dignify and impart greater apparent rigor to the efforts of planners and policy makers of all stripes throughout the developing world. In virtually every planning ministry (and countless World Bank country reports), the stated objective was to raise growth rates – preferably

[17] See Andrew Glynn (2006).
[18] See Olson 2000 and Bates 2008.
[19] Chenery and Bruno 1962. Hollis Chenery, the Bank's chief economist from 1972 to 1982 was responsible for embedding it into mainstream discourse.

to 7 percent per annum so as to double GDP in 10 years – by dint of industrialization and to do this through a combination of measures that promoted domestic resource mobilization and foreign exchange earnings - or alternatively in the case of relatively closed economies, such as China, by minimizing reliance on imports and reducing the need for foreign exchange.

Economics as applied to developing countries was focused on planning, had a strong theoretical flavor and little empirical content, and served more to justify existing practices than to explain them. As observed by Yusuf (2008), input-output (I-O) techniques that used flimsy data and were pressed into use to lend glamour and a measure of exactitude to planning at best did no harm. At worst, they created a corset of targets, controls and regulations that slowly began stifling economies where planning was king, as in the USSR and its satellites, but also countries such as India, which was growing at a disappointing rate. These were heady times for development economics, although its contribution to this prosperity was arguably trivial. I-O models, turnpike models, "golden rule" models, and other dynamic optimizing models employing mathematical techniques borrowed from the engineering sciences and topology celebrated the high growth rates and attributed this to advances in economic thinking. Greater access to computers coupled with progress in econometrics and software brought a flood of simulation results that appeared to light the way forward. The worth of this modeling and simulation is now debatable. Although the Harrod-Domar model lies at the root of the AK models, the current development literature has little use for turnpikes or golden rules or I-O based planning, or the large econometric models that attempted to represent the workings of economies, although computable general equilibrium (CGE) models remain in use.

The World Bank—where researchers came mainly from Harvard, Yale and Princeton, and a few élite educational institutions in India or Brazil—was actively working on Input-Output and Social Accounting Matrix based programming. It built some of the largest I-O models in the 1970s and contributed to the writing of the software to run these, e.g. GAMS. Stern and Ferreira (1997, p.556), reviewing research at the Bank during those days, remarked, "At one point it seemed as if the solutions to the problems of the world were perceived as lying in ever more disaggregated linear programming models."

An Overview of Development Thinking, 1960-2010

As mentioned earlier, before 1960, the economics of developing countries was very theoretical and focused mainly on planning. Empirical development economics began in earnest during the 1960s with Simon Kuznets, who received the Nobel Prize in Economics in 1971 for his empirical work on economic growth and the structure and process of development.[20] Four main "themes," which have influenced the discussions surrounding the preparation and implementation of IDA operations, can be discerned in development thinking.[21] These are: the importance of poverty and how to address this challenge; the role of economic incentives and the government vs. markets debate; the role of policy advice and its applicability to diverse situations; and the role of openness and the import substitution vs. export orientation debate. IDA has been an active contributor to research and has participated as an advocate of specific development views in the major ideological debates of the past decades and—being subject to fads and fashions like any other large organization—has also been strongly influenced by external views.

The Focus on Poverty

During the 1960s, the idea of development became inextricably linked with poverty reduction, and this opened a wide field for IDA. Since then, what we could call the "economics of poverty reduction" and the other main themes of development thinking have strongly influenced IDA operations.

The colonial powers had been greatly weakened by World War II and the reconstruction of Europe was the major enterprise of the 1950s. But by 1960, national independence movements—from China to India, Indonesia, Kenya or Central America and the Caribbean—had been strengthened; the Soviet Union was in ascendancy after the death of Stalin and communism was spreading its influence in the developing world. In

[20] For instance one of the great empirical achievements of the period was the "inverted U-hypothesis" formulated by Kuznets linking income growth to its distribution. It was put into question by François Bourguignon (another Bank Chief Economist) and other economists in the 2000s, in the light of new empirical data for the period 1950-2000.

[21] See Wolfensohn, James, and François Bourguignon. 2004. *Development and Poverty Reduction. Looking Back, Looking Ahead*. World Bank. Washington, DC.

the 1960s attitudes changed and became less patronizing toward less developed countries. It was difficult to ignore them and the "developing world" (or the "third world," a term coined by the French demographer and economist Alfred Sauvy in 1952)[22] became a concept capable of influencing foreign policy and generating institutional responses in rich countries. "Economic development emerged as a shared global enterprise, linking poor countries that had little in common but poverty, and tying rich and poor through the mutual need for security and a growing sense of moral obligation."[23]

The Cold War—which had begun even before the Korean War, continued with the nationalist coups in Egypt and Syria, and was about to deepen with Cuba's descent into communism in 1959 and the Vietnam war—had divided the world in two. Developing countries could opt for some variant of the capitalist model, with a greater or lesser dose of planning, or with the path being followed by the Soviet Union, China and the other socialist economies. In spite of political and economic attempts to avoid unavoidable choices, such as the 1955 Bandung conference of nonaligned countries and the self-managed enterprises of the "Yugoslav model," the countries of the Third World, by then, belonged—or were about to belong—to the "free world" or to the "Soviet bloc."

The creation of IDA in 1960 transformed the nature of the World Bank. As Kapur, Lewis and Webb recount in their detailed historical volume,[24] "the addition of IDA drew the institution into a whole array of non-self-liquidating fields including those of poverty alleviation and the social sectors, as was evident in the way agriculture began to take hold as a Bank subject even in the late Black years." Since the creation of IDA, the World Bank has attempted to link in a unique way its loan and credit operations with policy research and studies to inform its clients and staff about broader economic developments. Since then, the work of the Bank has been measured more in terms of the successful development of member countries than of the number of projects approved, the lack of defaults on past loans, or the rate of return on equity. And development itself is measured not only in terms of rising real gross national product but in improved public

[22] In the 1980s, Peter Bauer offered a competing definition of the term Third World. He claimed that the attachment of Third World status to a particular country was not based on any stable economic or political criteria, and was a mostly arbitrary process. The only characteristic that Bauer found common in all Third World countries was that their governments "demand and receive Western aid" (the giving of which he strongly opposed). See http://en.wikipedia.org/wiki/Third_World

[23] Kapur, Lewis and Webb (1997), p. 143

[24] Ibid., p. 1132

health, more equitable income distribution, declining rates of population growth, and greater political stability.

During the 1960s there was an increasing preoccupation with the gap between rich and poor countries, and how to reduce it. Starting in the mid-1960s, under the intellectual influence of Singer, Seers and others, the idea of development became less and less identified with material growth and more identified with processes of social change and poverty reduction. At the World Bank, the preoccupation with poverty reduction accelerated during the 1960s. It came into focus mainly after President McNamara's 1973 speech at the annual meetings in Nairobi, which emphasized poverty eradication as the true goal of development. One focus of research was how to promote the redistribution of income in developing countries so as to reduce the crushing burden of absolute poverty.

By the early 1970s, economists had lost confidence in the ability of economic growth to be a sufficient means to reduce poverty. There was a growing belief—backed by increasing evidence—that growth would not trickle down to the poor. One of the first major research efforts to dent trickle down confidence was the 1970 volume by Little, Scitovsky and Scott, *Industry and Trade in Some Developing Countries*, which linked excessive protection and limited job creation.[25] In 1974 the World Bank published *Redistribution with Growth* on policies to improve income distribution and employment, providing an intellectual rationale for the approach it was taking in "attacking" poverty through a number of production-oriented loans or social loans.

Poverty considerations were set aside during the long macroeconomic crisis that started at the end of the 1970s. The neoliberal perspective that dominated the 1980s considered that growth was all that really mattered for welfare outcomes, and that poverty and inequality would take care of themselves. Proponents of that view downplayed distribution and poverty, and insisted on re-establishing market mechanisms to promote economic growth. At the World Bank, funding for research on poverty and income distribution peaked in 1975, then declined considerably, reaching almost zero between 1980 and 1985.

[25] Ibid., p. 226.

A renewed emphasis on poverty reduction began in 1990. The understanding of poverty, under the influence of Sen and others, broadened from a narrow focus on income and consumption to a more complex vision of the linkages between growth and poverty reduction. Richer countries tend to have better social indicators. From this undeniable fact, the Bank drew the conclusion that human development promotes income growth and income-poverty reduction. Not all economists share this view.[26]

The emphasis on poverty in the 1990s was not new. What was new from the late 1980s onward was the articulation of a more complete strategy, combining growth with delivering social services (education, health and social protection) to the poor. In other words, it was the recognition that it was not growth alone that would do it—which was implicitly the view of the 1980s. At the World Bank, the change was spearheaded by the *1990 World Development Report* on Poverty, which included the first standardized global estimates of the prevalence of poverty, and by a shift in the institution's emphasis after the arrival of James Wolfensohn as President in 1995. There was an expansion in analytic tools and capabilities, in both data and methods, linking micro data to aggregate outcomes, and with a view toward assessing policies and programs. This was built on the rapid expansion in household survey data production, which started in the mid-1980s.

Since then, development economics—moving away from macroeconomic explanations à la Keynes or Harrod/Domar—has increasingly emphasized the microeconomic foundations of development. Researchers and policymakers have realized how crucial micro-level decisions are for economic growth. Examples are the role of women in household decision-making; the effects of the proportion of household resources controlled by women on the health and nutrition of their children; the role of microeconomics in poorly functioning land, labor, and credit markets; and the role of informal networks and institutions in dealing with market failures. The aim of this micro development literature is to understand what institutions may arise at the micro level to cope with such failures and to structure policy to provide for them.

[26] For a dissenting view, see Sudhir Anand and Martin Ravallion, "Human Development in Poor Countries: On the Role of Private Incomes and Public Services," *Journal of Economic Perspectives*, Vol. 7, No. 1 (1993), pp. 133-150.

Recent research, both theoretical and empirical, has emphasized that there need not be a trade-off between growth and equity, and that inequality could slow the pace of poverty reduction. Kuznets, Chenery and development economists in the 1970s posited that although inequality was undesirable as an end, it was a means to long-run growth, because wealthy people tended to save and invest more of their incomes. The central policy challenge for the Bank in the 1970s was to achieve as much growth as possible and then to redistribute. In the 1990s, the view—originating in research described in the World Bank's *2006 World Development Report*—changed. Economists saw that there did not necessarily have to be a trade-off between growth and distribution of income. Policies aimed at reducing sharp inequalities and equalizing opportunities were having positive results for both efficiency and equity. For instance, ensuring access to education and health care improves the productivity of the poor, boosting their quality of life and potentially the dynamism of society. Access to work opportunities decreases the likelihood that people will resort to crime. Because economic power often translates into political power, greater equity can underpin a broader targeting of public policy. If well executed, measures to equalize opportunities for people to lead productive lives are good for consensus, social justice, political stability, and productivity.

This has led to the view—now shared by most development economists—that the economy grows and develops best when the majority of the population can participate in and benefit from growth. This view is described at length in the *2006 World Development Report* on Equity. Development strategies should aim to reduce sharp inequalities and equalize opportunities, and would thus improve both efficiency and equity.

The Role of Incentives and the State vs. Markets Debate

In most developing countries in the 1950s and 1960s, the dogma of planning held sway, with its emphasis on pervasive market failure and the need for a highly interventionist state. By the 1980s, the neoliberal counterrevolution had taken hold. Where the planners saw market failure, the neoliberals saw massive government failure, and their response was to move developing-country economies toward unregulated markets. "Getting prices right" was the mantra—an important corrective to the planning ideas, but equally incomplete as an approach to development. These competing

ideologies continued to drive decision-making in many countries even after deeper economic analysis and extensive evidence undermined their credibility. The polarization of development debates and the lack of rigor in policy analysis did little to further the cause of poverty reduction.

In the 1990s, the development community largely moved beyond the twin dogmas of pervasive state control (1960s–1970s) and unregulated markets (1980s–early 1990s). The latter half of the decade witnessed the gradual consolidation of a consensus that states and markets are in fact complementary. Private enterprise operating through the market is the main engine of sustained economic growth. But keeping that engine running and ensuring that it powers poverty reduction require a state that is active in two key areas. First, government needs to ensure that the business climate is conducive to growth. Second, government needs to invest in and empower its people, particularly poor people who might otherwise be excluded, through education, health, social protection, and mechanisms for encouraging voice and participation. Without broad participation and more human capital, growth is unlikely to be fast and sustainable—because excluding large segments of society wastes potentially productive resources and breeds social conflict.

Policy Advice: From the "Washington Consensus" to Country Specificity

With the dogmas of the state-market debate came an insistence on "mono-causal" explanations of development. This led to one-size-fits-all policy approaches, as the general models left little room for actual conditions. When mainstream development thinking discarded one model in favor of another, the result was too often major changes in policy recommendations without room for nuance. The most recent (but certainly not most simplistic) manifestation of this was the "Washington Consensus" at the beginning of the 1990s. Its list of preconditions for growth encapsulated many neoliberal precepts in what was often interpreted as a neat recipe for development. Perhaps unfairly, that consensus came to stand for a package of measures aimed largely at getting the government out of the economy—and it was applied with excessive uniformity across countries.

Common sense tells us that no one approach will work everywhere, since the binding constraints to development are unlikely to be the same across countries. Development theory is catching up with this view. Even under the simpler earlier models, outcomes of policies depended on the parameters assumed for a given country. But the case for country specificity received a boost in the late 1980s and 1990s, as a flowering of theoretical work on new multiple-equilibrium and endogenous-growth models emphasized initial conditions.

Take trade restrictions and import-substituting industrialization. The new pragmatic consensus now justifiably advocates more liberal trade regimes for most countries—but recognizes that the costs of following an import-substitution industrialization strategy varied with the country's characteristics. In large economies with access to foreign technology and equipment, competition and economies of scale moderated the inefficiency cost of trade restrictions. At least in earlier decades, India, China, and Brazil were able to develop manufacturing with fairly closed domestic economies, and some became internationally competitive. But in small countries such as Jamaica, Sri Lanka, and Uruguay in the 1960s and 1970s, the market was too small, and any benefits of inward-looking industrialization were swamped by the costs. Sri Lanka began to grow only after it turned toward export-oriented policies in 1977.

Institutional variation also shapes policy outcomes. In Japan during the Meiji period, and more recently in Korea, public institutions narrowed interest-group pressures, at least enough that they did not block development. Public enterprises were run efficiently and built capacity in sectors that paved the way for private investment. Although governments played a role in allocating credit and foreign exchange, they did so more heavily on the basis of performance than is typical in other countries. But in Bolivia, Zambia, and other countries, where public enterprises and allocations were captured and used for patronage, the same strategies undermined industrialization.

Country specificity means that the key is addressing the binding constraints for growth at the right time in the right way, not adopting any one-size-fits-all policy packages. Identifying the most binding constraints and the best policy mechanisms to overcome them certainly is not obvious, putting a premium on sound analysis and the ability to experiment. Much remains to be done in this area.

Globalization, Openness and Economic Integration

The crises of the 1990s and 2000s highlight the importance of prudent macroeconomic management, whether to control booms or to reduce vulnerabilities. Development policy has had to adapt to the deepening of cross-country interdependencies—to what is usually called "globalization." Economic integration on a grand scale is nothing new: cross-border flows of labor and capital in the 19th and early 20th centuries were impressively large, with European bond investors financing much of the railroad infrastructure in the Americas, to take one example. But the recent globalization trends are exceptional in three main ways. First, the costs of transporting goods across borders are now far lower, which, thanks to trade liberalization, has boosted trade flows at rates far faster than global income growth. Second, information, including new technologies, now flows instantaneously around the globe in quantities unimagined in earlier decades. Third, as demonstrated during the present global crisis, portfolio capital can now move extremely rapidly into and out of a larger number of emerging markets in response to changes in local conditions or investor sentiment.

These changes offer new opportunities to developing countries, for example by allowing them to become integrated into global production chains. But they also bring new risks and vulnerabilities, particularly to poor countries. Stronger links between economies mean that shocks in industrialized or rapidly growing countries can be transmitted to smaller countries less well-equipped to cope with them. The ripple effects of the East Asian and Russian crises of the late 1990s and the financial crisis of 2008-2009 demonstrated this all too well. Similarly, trade and aid can benefit poor countries, but unexpected drops in either—perhaps caused by economic decline in rich countries or new waves of protectionism—will have destabilizing effects on their economies. Such shocks could drag many poor countries back below the threshold of sustainable debt. Poor countries also suffer from migration barriers and credit constraints that keep unskilled labor from flowing out, while highly educated people exit freely and in large numbers.

Globalization brings other "public bads." Among them is the damage that economic growth inflicts on the environment, both in developed and developing countries, particularly through greenhouse gas emissions. Breaches in security are also

being felt as a global public bad, and the imbalance of global development has been blamed for it. It is certainly difficult to trace all international security problems directly to economic development issues, but the links are obvious in several instances: national conflicts spilling over to neighbors and forcing foreign intervention, and failed states threatening global stability.

Policy Research at the World Bank

Economic research at the World Bank started in earnest at the time of the creation of IDA during the presidency of George Woods (1963-68). Irving Friedman was brought to the Bank from the IMF—as Director of Economic Research and Economic Adviser to the President. Woods and Friedman provided the rationale for the concessionary aid program and helped to make the Bank the world's foremost development agency. Andrew Kamarck became Director of the Economics Department.[27] In four years, Friedman and Kamarck recruited more than 200 social scientists, mainly Ph.D. economists,[28] and sought additionally to have economic analysis carried out within area departments as well as the Economics Department.

But it was Hollis Chenery, a leading Harvard economist who had been assistant administrator for the USAID program and succeeded Friedman in 1970, who gave development policy research its central role in the Bank. Chenery's focus was on producing quantitative research and statistical work on the growth and distribution of national income and the structure and process of development. Chenery was particularly influential in advising McNamara on how to promote the redistribution of income in developing countries so as to reduce the crushing burden of absolute poverty. During the same period, Bank research staff also produced quantitative forecasting and planning models (such as general equilibrium models). Since Chenery joined the Bank, "in general, World Bank economists have become leading contributors to development research, and the Bank is better

[27] Friedman and Kamarck had worked on the Bretton Woods proposals at one time or another within the US government, and had expertise in both theoretical and applied economics. Woods was eager to transform the Bank from a bank to a development finance agency and felt that he needed the assistance of an economics staff in order to do that. He is reported to have said, "I don't think you can have a development agency unless it has as its fuselage the loans which are being made, but one wing has to be project work and the other wing has to be economics." (Oliver 1975)

[28] The Young Professionals Program had been created in June 1962.

able on that account to deal with the development priorities of the world."[29] In his 1970 speech to the Board of Governors in Copenhagen, the President of the Bank addressed the question of what needed to be known to be able to do good lending and advisory work in developing countries:

> We do not want simply to say that rising unemployment is a "bad thing," and something must be done about it. We want to know its scale, its causes, its impact and the range of policies and options which are open to governments, international agencies and the private sector to deal with it.
> We do not want simply to sense that the "green revolution" requires a comparable social revolution in the organization and education of the smaller farmer. We want to know what evidence or working models are available on methods of cooperative enterprise, of decentralized credit systems, of smaller-scale technology, and of price and market guarantees.
> We do not want simply to deplore over-rapid urbanization in the primary cities. We want the most accurate and careful studies of internal migration, town-formation, decentralized urbanism and regional balance.[30]

In the fall of 1972, the Bank underwent a re-organization. Most sector issues were the responsibility of the Central Projects Staff (CPS), while most broad questions of development policy were to be addressed by the Development Policy Staff (DPS), known as the "Economics Department," given responsibility for macroeconomic research. Hollis Chenery became the first Vice President for Development Policy. A comprehensive review of research in the Bank was carried out by Bela Balassa in 1971 and a Research Committee was established to advise the President in shaping the Bank's research program.

An important vehicle to disseminate the Bank's views on development, to mobilize official development assistance and to win adherence for a renewed push for development is the annual *World Development Report*, which appeared for the first time in 1978. The intense interest aroused by a paper on global trends and the prospects for developing countries issued in 1974 by Hollis Chenery encouraged McNamara to pursue the idea of an annual publication that took the pulse of the international economy, stimulated the search for answers, and synthesized the consensus view.

In 1982, A.W. Clausen replaced R. McNamara as President, and Anne Krueger replaced Hollis Chenery. The Development Policy Staff became the Economics Research Staff (ERS) and, shortly thereafter, Anne Krueger became the new Vice President, Economics and Research. Research on basic development issues was concentrated within ERS in the Development Research Department (DRD). Simultaneously, the Central Projects

[29] Oliver (1975)
[30] Mason and Asher (1973), p. 476-477.

Staff was reshaped as the Operational Policy Staff (OPS) whose mandate was, among other things, to conduct applied policy research in close collaboration with operational staff. Within OPS, the Country Policy Department was to act as the "applied counterpart" of the Development Research Department. Within the Economic Research Staff (ERS), the Development Research Department (DRD) was responsible for macroeconomic research. The Central Projects Staff became known as Operations Policy Staff (OPS), with responsibility for research on sector and micro topics.

The new Vice President and her team reorganized research at the Bank. Prior to the reorganization, the "Economics Department" (DPS) accounted for 70 percent of Bank research expenditures, with the remaining 30 percent being in Operations. The reorganization would change this balance radically: after the reorganization, more than one-half of Bank research would be located in and managed by departments in Operations. By 1983, research resources were shifted toward operations: research resources controlled by ERS dropped to slightly below 50 percent. Research funds were concentrated in a few large cross-country comparative research projects with several small projects. Anne Krueger and the Research Policy Council, which advised her, also established a *Research News Bulletin* and the two journals, the *World Bank Research Observer* (WBRO) and the *World Bank Economic Review* (WBER)—the news bulletin and the WBRO targeting the widest range of readers interested in development, and the WBER intended for economists.

Under Anne Krueger's leadership, research moved away from what was characterized as "engineering economics" with its emphasis on large-scale quantitative forecasting and planning models, toward studies that emphasized factual behavioral patterns.[31] This shift implied greater emphasis on research oriented toward making policy and less toward understanding what would happen in an optimizing society where all regulations could be exogenously imposed and costlessly enforced; it represented a departure from large modeling enterprises for planning and forecasting and a reorientation toward studies of how individuals, institutions and governments behave in different economic environments. Policy research was primarily carried out through a series of large-scale studies of major development issues, each built on in-depth comparative analysis of 20 or so country experiences. The Comparative Studies Program dominated the course of centrally funded

[31] This is the language used in the evaluation of World Bank research by Assar Lindbeck, Director of the Institute of International Economics in Stockholm, presented in the 1984 Annual Report on the World Bank Research Program to the Board of Directors.

research for most of the 1983 through 1987 period and was the principal mechanism used by the Research Policy Council to translate research priorities into action.

In 1987, as Barber Conable succeeded A.W. Clausen as President, a Policy, Planning & Research (PPR) complex was created to integrate policy and research. PPR encompassed, *inter alia*, Development Economics (DEC), Sector Policy & Research, and Strategic Planning & Review. Stanley Fischer succeeded Anne Krueger as Chief Economist. An informal review of the Bank's research portfolio and research program was conducted at the time of the reorganization by Bela Balassa, who had written the report leading to the creation of the Research Committee in 1971. The 1988 research report sent by Stan Fischer to the Board states that, "The Bank's research program continues to evolve as priorities change […]. During the late 1960s and the 1970s, concern about distributional issues and poverty strongly influenced the direction of Bank research. In the early 1980s, […] as interest in policy-based lending increased [because of] global economic conditions, so too did the demand for research on macroeconomic and international issues. Although a large component of the research program continued to be devoted to analyzing the problems of the poor and the ways of alleviating poverty, the problems of structural adjustment and stabilization generally overtook distributional concerns to become the dominant issues facing many of the Bank's clients. Four patterns in the makeup of the research budget since the early 1980s are noteworthy: (1) the rising share of departmentally approved research, (2) the rising share of research on macroeconomic and international issues, (3) the move toward small and very large projects, and (4) the scant involvement of the regional staff in research." These four features do not seem to have changed much in the past 30 years. Stan Fischer created three new instruments: the Annual Bank Conference on Development Economics (ABCDE), the Visiting Research Fellows program and the Research Capacity-Building Grants to research institutes in developing countries.

The Bank adopted its current matrix structure at the 1997 reorganization.[32] Six Networks were established to bring sector expertise, multi-country experience and research to bear on operations and policies. In 2006, the Bank consolidated the six Networks into four. Research was consolidated under the Chief Economist and Vice President for Development Economics and the new Vice Presidency became known as Development

[32] Thematic Vice Presidencies for policy guidance, operational support and dissemination of best practice to operations—the forerunners of the Networks—had been established in October 1992. Regional Technical Departments were made smaller and the sector operations divisions were strengthened.

Economics (DEC). Michael Bruno was appointed Vice President in September 1993, replacing Lawrence Summers, who left the Bank in January 1993. DEC had responsibility for micro and macro-economic research and conducted a significant share of sector studies.

The Country Economics Department (renamed Policy Research and, later, DEC Research Group) became the principal research arm of the World Bank—covering the full range of issues relevant to development policy in the Bank's member countries—during Nancy Birdsall's tenure (1991-1993).[33] In 1992 the Bank began publishing synthetic reports aimed at summarizing research findings to provide the basis for sound policy advice on specific topics—known later as Policy Research Reports (PRRs). The first two reports were *The East Asian Miracle* and *Adjustment in Africa: Reforms, Results and the Road Ahead*, both carried out under the general direction of Nancy Birdsall. The third report, *Averting the Old Age Crisis*, was initiated by Lawrence Summers and Nancy Birdsall and carried out under the general direction of Michael Bruno and Lyn Squire. Since then, 14 more reports have been published.[34]

Today the World Bank is considered to be the leading intellectual institution in development and a world leader in a number of important research areas, including poverty measurement, delivery of social services, impact evaluation and measurement of development outcomes.[35] Bank research is resolutely oriented toward policy. Researchers play a crucial role in both learning from past policies and thinking critically about future policies. Without research, the conceptual foundations for policy making would be weak; there would be very little new knowledge or data to inform policy decisions; there would be little or no innovation; and we would know too little about what succeeds and what fails in

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[33] The department has had four directors after Nancy Birdsall: Lyn Squire (1993-1996); Paul Collier (1998-2003); Alan Winters (2004-2007) and Martin Ravallion (since September 2007).

[34] The East Asian Miracle (1992); Adjustment in Africa (1993); Averting the Old Age Crisis (1994); Bureaucrats in Business: The Economics and Politics of Government Ownership (1995); Private Capital Flows (1996); Confronting AIDS: Public Priorities in a Global Epidemic (1997); Assessing Aid: What Works, What Doesn't and Why? (1998); Greening Industry (1999); Trade Blocs (2000); Engendering Development (2000); Finance for Growth (2001); Globalization, Growth and Poverty (2001); Breaking the Conflict Trap (2003); Land Policies for Growth and Poverty Reduction (2003); Reforming Infrastructure: Privatization, Regulation, and Competition (2004); At Loggerheads? Agricultural Expansion, Poverty Reduction and Environment in the Tropical Forests (2005); Finance for All? Policies and Pitfalls in Expanding Access (2007) and Conditional Cash Transfers (2009).

[35] These are the conclusions of a 2006 evaluation report, prepared by a panel headed by Angus Deaton and comprising some 25 world-renowned development economists, asked to assess the relevance and quality of Bank research.

the fight against poverty. Without research, failed policy orthodoxies would often persist without the critical inspection needed to show that they have failed and successful policies would be dropped for the wrong reasons.

In recent years, the World Bank research program has increasingly been involved in two broad cross-cutting types of research: evaluative research and methodological research.[36] Evaluative research rigorously assesses whether development policies are effective, and under what circumstances they tend to be more effective. This embraces both "micro" interventions in specific sectors and macro policies. The second type of cross-cutting research that has increasingly occupied Bank research in the past decade can be termed methodological research. The Bank has become a major producer of development data, and a number of the Bank's most successful data initiatives started as research projects. The best example is probably the *Living Standards Measurement Study* (LSMS), which started as a research project in the mid-1980s with the aim of greatly improving household survey data in developing countries. The LSMS database now houses more than 75 LSMS datasets with all the relevant documentation. The World Bank is also a leader in governance indicators: enterprise surveys (also known as Investment Climate surveys), and Purchasing Power Parity measurement through the International Price Comparison Project.

Shifts in Country Allocations, 1961 - 2010

Before the early 1990s, with a few exceptions (such as P.T. Bauer), the economic literature on the effectiveness of aid in general, and IDA in particular, was inconclusive and consisted mostly of general studies and cross-country regressions.[37] Initial cross-country results, which emphasized growth to reduce poverty based on the Washington consensus, sound fiscal and monetary policies, openness, liberalization of markets and deregulation. However, as it has been difficult to find robust evidence from cross-country data that the policy prescriptions of the Washington consensus – hence, aid based on those - generate growth, subsequent empirical work by researchers from the World Bank

[36] See Martin Ravallion, "Research in Practice at the World Bank," DECRG, September 2007.

[37] The most well known was probably the 1986 volume by Robert Cassen (who had been the main author of the 1981 World Development report), *Does Aid Work?* Oxford: Clarendon Press

and elsewhere have laid out more nuanced positions (Besley and Burgess 2003, Easterly and Serven 2003, Aghion and Howitt 2009).

Starting in the late 1980s, the idea of selectivity began to take shape. In 1998 the Bank published a Policy Research Report, *Assessing Aid: What Works, What Doesn't, and Why*, which turned out to be very influential, arguing that foreign aid would have a greater impact on poverty reduction if it were focused on poor countries with stronger economic institutions and policies. The recognition that the effects of aid depended heavily on the environment was a major step forward. Subsequent work by Burnside and Dollar (2000) has reinforced this finding and since then there has been an explosion of empirical work in this area. On the one hand, some researchers have challenged the robustness of these results (Hansen and Tarp, 2001, Easterly and Levine, 2003, and Rajan and Subramanian, 2008). Some studies, on the other hand, tend to find a beneficial effect of aid, differing primarily on how much the beneficial results depend on the environment, especially over a longer period (Minoiu and Reddy, 2009). On this point, case-study evidence seems more consistent with the *Assessing Aid* argument. However, as pointed out by Temple (2010), empirical work based on cross-country data remains work in progress and this line of research is best at providing a signpost for more focused work (Besley and Burgess, 2003).

A second major advance has been the recognition that successful development assistance requires a conducive political economy in the recipient country. The failure of many structural adjustment programs in the 1980s, whether because of flawed design or poor implementation, underlined the country ownership of reforms. Empirical evidence suggested strongly that conditions on loans—that is, promises of future reforms—were far less reliable as guides to the borrower's reform commitment than past actions. As a result, the extensive use of conditionality fell out of favor with development thinkers. New studies provided evidence that aid was highly fungible: foreign aid to one sector often had the effect of financing investments in another sector on the margin, because the recipient government could redeploy its own resources from the first sector to the second, undermining the intent of the donor. For development assistance to make a positive contribution, therefore, it was necessary that the broader public expenditure program be

consistent with development aims. It no longer sufficed to ensure that a single project was well designed and implemented.

Both advances in thinking would have the effect of shifting development resources from countries with poor policies, institutions, and governance to those with better environments for growth, and were further reinforced by influential papers of Acemoglu, Johnson, and Robinson (2001) and Hall and Jones (1999). Both papers have shown that institutions and government policies determine the economic environment within which individuals accumulate skills and firms accumulate capital and produce output and are the main determinants of growth. Physical and human capital as well as prudent monetary and fiscal policies are "proximate" but institutions are "fundamental" determinants (Acemoglu, 2009). Although developing institutions or supporting countries to do so has strong economic justification, it raises a troubling question: What could the development community do to help the hundreds of millions of people living in the countries with the poorest aid environments? More recent work has begun to address this question, and while it is too early to assess whether that work will bear fruit, merely putting the question squarely on the development research agenda is a major advance. A particular challenge for IDA and the development community in general is how to support institutional development through policy advice. As noted by Rodrik (2007), first-order economic principles (protection of property rights, market-based competition, appropriate incentives, sound money, and so on) do not map into unique policy packages.

The same question is valid for aid allocation. What is the appropriate or reasonable basis to allocate scarce concessional aid resources? This question has received considerable attention in the development community. The approach of IDA, drawing on lessons from the past and influenced by changing development thinking and donor views (which have often influenced IDA during replenishment negotiations), has evolved over time. Initially needs-based—with needs proxied by income per capita and population in the early 1960s—the allocation of IDA funds has become increasingly based on performance. As noted by Stern, "too often, during the Cold War, aid allocations were driven by geopolitical aims rather than by poverty reduction goals." To counter the politicization of aid, IDA first introduced selectivity to inter-country allocations in its allocation system; then, during IDA's 12th replenishment negotiations, it gave more

prominence to governance ratings. This was a conscious political decision that followed the end of the Cold War.

The current performance-based allocation (PBA) system uses Country Performance Ratings (CPR) largely based on its Country Policy and Institutional Assessment (CPIA), a yearly assessment of policies and institutions by IDA and IBRD country teams along 16-point criteria grouped into four clusters.[38] The cluster that evaluates performance in governance accounts for 68 percent of the weight and the other three clusters—macro management, structural policies, and social policies—have a weight of 24 percent of the total.[39] An assessment of portfolio performance also enters into the formula with a weight of 8 percent. Then the CPR is raised to its 5th power and multiplied with population and GDP per capita raised to a negative power (-0.125) to direct more IDA resources to its poorer members out of equity considerations. With such a complex formula, IDA attempts to balance needs and performance. However there are also exceptional allocations for post-conflict countries, debt sustainability, regional projects, arrears clearance, and re-engaging countries. Yet allocations are highly selective and countries scoring high can expect to receive six to seven times the per capita allocation of low-scoring countries (World Bank 2001).

The document "Enhancing IDA's Performance Based Allocation System" (prepared for the IDA13 replenishment negotiations) mentions that a country's quality of governance can be seen as a proxy for its ability to effectively use additional funding, or absorptive capacity. The IDA12 discussions focused on the sharply reduced absorptive capacity of a number of countries in which a minimal level of governance was lacking and IDA12 introduced a governance discount on the overall rating, based on the country's performance with respect to seven governance criteria (six are part of the CPIA6; one is part of the ARPP and concerns the procurement process). The discount works as follows: criteria are rated on a scale from 1 (low) to 6 (high). If three or more of the seven governance criteria are rated 2.0 or lower, a governance discount of one-third is applied to the country's overall IDA Performance Rating. Since the allocation formula

[38] For a useful description of the CPIA, see Kanbur 2005.

[39] The weight of the portfolio implementation experience was increased at the time of IDA12 from 7 to 20%, in recognition of its relevance to the aim of allocating IDA funds where they may be expected to be used most effectively.

more or less squares the performance rating, the allocation impact of the discount is even greater, reducing the country allocation by some 50 percent. Donors and IDA Deputies later expressed satisfaction that the governance discount mechanism had achieved a number of objectives: (i) signaling concerns about weak governance; (ii) making governance a key focus of country dialogue and policy reform; and (iii) sharply reducing the allocation of funds in cases of weak governance, where there was a significant risk that IDA resources would not be effectively used. As a result, the ratio of average per capita allocations to countries in the top and bottom quintiles was nearly doubled, from 2.3 when the original rating was used, to 4.2 when the governance discount was applied.

Both the changing thinking on development as well as political factors affected the evolution of the PBA. Initial allocations were mostly based on "needs" and lack of capital and savings in poor countries, as emphasized by two gap models, while later allocations were affected by factors related to governance. This is in line with recent academic research which emphasizes institutional development; but it can be criticized on several fronts. There is no empirical grounding, for example, for the weights attached to its clusters or for the overweighting of its governance cluster, which was a political decision. Ratings along CPIA's 16 criteria have also been criticized as subjective and it is clear that the PBA is not a perfect rationing mechanism. It nevertheless is a transparent system and IDA's PBA has been rated the most transparent by external agencies and by researchers.

Shifts in Sector Emphasis, 1961 – 2010

During the past 50 years, there were several shifts in what were considered priority sectors for IDA. As recounted earlier, there was a first shift in the 1960s from "brick-and-mortar" and infrastructure projects toward a broader range of areas in McNamara's time, including social sectors, in large part because of the Bank's focus on poverty. This has continued, with perhaps greater emphasis on poverty and some inclusion of gender – but this is seen also as an issue of production efficiency. Agriculture was always high on IDA's agenda. This was modified in the early 1990s, as this sector lost its status because of low global prices and also due to poor performance of

traditional projects in the more liberalized agricultural sectors. The priority sectors became health, education, and social assistance—or broadly speaking, human development. Infrastructure continued to be important but lost to "soft" sectors during the 1990s. There was also an increased interest in public-private partnerships and instruments to "crowd in" private infrastructure funding.

These sector shifts are shown in the table below, which presents the breakdown of IDA grants by sector of activity over the 50-year period.[40] Six major trends are noticeable.

- The importance of agriculture and rural development increases steadily until the early 1980s and then gradually declines. It seems to have stabilized over the past decade at about 9 percent of total disbursements.
- Infrastructure—including electric power and energy, roads and transport, and telecommunications—which amounted to more than 40 percent of total IDA loans during the 1960s, has always been important but declined during the 1970s and 1980s and since the early 1990s has hovered around 20 percent of total grants.
- Grants for industry have accounted for about 5 percent of the total. This included a number of industrialization projects in the first years of IDA. It also includes an (almost constant) number of projects in mining and extractive industries, major export revenue earning activities in many poor countries. There were two highs of 10 and 13 percent, respectively, in the first part of the 1970s (probably explained by a large number of newly independent nations) and the first part of the 1990s in transition countries for industrial and financial restructuring projects.
- Social sectors—including education, population, health and nutrition, and social protection—increased from 6 percent in the early 1960s to 17 percent in the early 1990s, and reached a high of 30 percent in 2000-2005, declining slightly to 28 percent in the last 5 years.

[40] The first part of the table reports numbers on a commitment basis and is based on the data from the report *IDA in Retrospect* published in 1982 on the occasion of the first twenty years of IDA. The second part reports numbers on a disbursement basis and is based on the grant/loan database managed by the World Bank.

OPERATIONS OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION BY SECTOR (in percent of total credits)								
	1961-70	1971-76	1977-82	1984-90	1991-95	1996-2000	2001-05	2006-10
Agriculture & Rural Dev	23	32	42	34	23	14	9	9
Energy	6	8	16	11	7	8	8	9
Transport	30	17	10	13	12	12	11	12
Telecomm	5	5	3	3	1	1	1	1
Infrastructure	41	30	29	27	20	21	20	22
Water supply & sewerage	3	3	5	4	6	8	6	7
Urbanization	0	1	2	2	1	0	0	0
Other Infrastructure	3	4	7	6	7	8	6	7
Industry	4	10	8	6	13	9	5	4
Education	6	5	6	6	9	12	12	13
Pop, health & nutrition	.	1	1	2	8	13	18	15
Social Sectors	6	6	7	8	17	25	30	28
Governance	.	.	.	2	14	18	24	25
Nonproject lending	23	18	7	.	.	.	.	.
Multisector	.	.	.	13	2	0	0	0

"." means not available or non existant category

sources: 1961-82 on a commitment basis (from IDA in retrospect, 1982)

1964-2010 on a disbursement basis (from Business Warehouse database)

industry includes mining and finance

governance includes public administration and law

categories do not add up to 100 due to rounding errors

- "Social infrastructure" which includes mostly water, sewerage and sanitation as well as a number of urban activities (housing and others), from the late 1970s until today represents a respectable 6-8 percent of the IDA portfolio. The largest number of grants is for water and sewerage in the growing urban shantytowns of poor countries.
- Grants for governance projects, which include public administration and law, have experienced the most remarkable progression. The category did not even exist until the 1980s. Since then, they have grown from zero to 25 percent of the total IDA portfolio in the last 5 years.

Agriculture and Rural Development

As mentioned earlier, the Bank did not put any emphasis on agriculture during the 1950s because it viewed industry as the engine of development, comforted in this respect by the views of all important development economists (from Arthur Lewis, to Albert Hirschman to Walt Rostow) who felt that "traditional agriculture was the sector from which resources of some kind needed to be extracted on behalf of industrialization."[41] This changed completely during the 1960s under the Presidency of George Woods and even more so during the 1970s under Robert McNamara. Agriculture was a key preoccupation for IDA and other DAC donors—and, of course, for developing country governments—from the 1960s until the early 1980s but it gradually disappeared from the development agenda for almost 20 years, only to reappear in the first decade of the 21st century. A symbolic date for the "reappearance" of the sector in the consciousness of the international community was the publication date of the *2008 World Development Report* on Agriculture. Agriculture had not been a focus of the *World Development Report* since 1982.

Agriculture is important for economic growth as well as for poverty reduction. In poor countries, the agricultural sector is large in terms of both aggregate income and share of the total labor force—not only for the overall population but for the poor in particular. Today the sector accounts for 25 percent of GDP in low-income countries and 9 percent in middle-income countries (but only 1 percent in high-income countries) and, in agriculture-based countries (i.e., those in which agriculture accounts for more than a third of overall growth), 65 percent of the labor force is employed in agriculture. Agriculture is the main source of livelihood for 86 percent of rural households (which themselves represent 55 percent of the population of developing countries). Some 75 percent of poor people still live in rural areas and derive the major part of their income from the agricultural sector and related activities.

The major intellectual influence when the Bank began to increase its lending came from T.W. Schultz whose 1964 book *Transforming Traditional Agriculture* had a profound influence on the profession in general. Contrary to the view that peasants in

[41] See Kapur Lewis and Webb, p. 381

poor countries were "traditional," Schultz considered that they were rational decision-makers and maximized the return from their resources. Their apparent unwillingness to innovate, he argued, was rational because governments of those countries often set artificially low prices on their crops and taxed them heavily. In other words, peasants respond to incentives. Empirical support for this view was overwhelmingly produced (much later) in a multi-country study on the Political Economy of Agricultural Pricing Policy, led by Anne Krueger, Maurice Schiff and Alberto Valdès. The study demonstrated that price policy, trade policy and exchange rate policy in virtually all developing countries have discriminated against agriculture, either directly through food subsidies or taxes on agricultural exports, or indirectly through manufacturing protection and exchange rate overvaluation.[42] The study was recently updated, under the direction of Kym Anderson, and reached the same conclusions.[43] Since the mid-1980s many developing countries have undertaken a great deal of policy reform and opened to trade. The inter-sector bias against agriculture and the antitrade bias have been reduced substantially. Developing countries have benefited proportionately more (relative to GDP) than high-income economies from those trade-related policy reforms, and they would gain nearly twice as much as those richer economies by completing that reform process – with 72 percent of the prospective gains to developing countries coming from agricultural and food policy reforms. In developing countries, net farm income (agricultural value added) is estimated to have been 5 percent higher in 2004 than it would have been without the reforms since the mid-1980s. And if policies remaining in 2004 were removed, that net farm income would rise by another 6 percent (far more than the proportional gain to nonagricultural households). These reforms could further alleviate global inequality and poverty, since three-quarters of the world's extreme poor are in farm households in developing countries. One way to look at the policy changes of the past 25 years is to say that developing countries follow the example of higher-income countries in moving from anti- to pro-farmer policies as they develop. The Anderson study shows that import-competing farmers in developing countries are being increasingly protected over time.

[42] Krueger, Schiff and Valdès. 1991-1992.
[43] Kym Anderson, 2009

One factor responsible for the emphasis on agriculture was the concern about "feeding the world population," and especially the most populous nation at the time, India. South Asia experienced two major droughts in 1965-66 and 1966-67 and food aid shipments to India alone amounted to 10 million tons per year.[44] At that time, the "Green Revolution" began and, under funding and leadership from the Rockefeller and Ford Foundations, dramatic improvements were achieved in plant breeding, especially for maize in Mexico, rice in the Philippines, and wheat in the Punjab. The World Bank, which soon jumped on the bandwagon, has sometimes been accused of taking too much credit for the Green Revolution.[45] But whatever its role, it remains the case that there was a rapid expansion of IDA credits (and IBRD lending). About half of the credits went to irrigation and drainage (on which the Green Revolution relied); between 10 and 15 percent went to agricultural credit; and a sizeable share (7.7 percent in the 1960s, increasing to 18-20 percent in the 1970s and 1980s) went to "area development," i.e., rural development.

Agricultural production grew fast, especially in Asia and Latin America. Between 1961 and 2004, yields in Asia rose at an average rate of 2.8 percent, an outcome largely explained by the adoption of high-yielding varieties and the intensive use of fertilizer. In other parts of the world, results were less impressive. In Sub-Saharan Africa, growth per capita of the agricultural population (which is a broad measure of agricultural income) was less than half the growth rate in other regions. Whereas agricultural growth in Asia and, to a lesser extent, Latin America was driven by intensification, agriculture in Sub-Saharan Africa grew mostly as a response to land expansion and yields have been stagnant. Since the potential for land expansion will soon be exhausted, further agricultural growth will have to come from increased yields.

During the 1960s, rural development programs included the diffusion of technology to smallholders through government agencies, as well as community development in which members of communities were given joint responsibility to manage their community resources. Self-help efforts were encouraged and villagers were supposed to establish their own development plans—involving infrastructure, education

[44] Kapur, Lewis and Webb, page 387
[45] Kapur Lewis and Webb p. 390 and John P. Lewis, 1995.

and agricultural improvements—while outside experts provided advice and grants. These early attempts at rural development failed because communities were not given additional resources, old power structures persisted, and traditional elites prevented these programs from reaching the poor (Holdcroft 1978). As GDP growth in developing countries slowed during the 1970s, it became clear that growth was not trickling down automatically to the poor. The focus of rural development approaches shifted toward poverty reduction.[46]

The leading approach to achieve this goal in rural areas became Integrated Rural Development (IRD) intended to focus directly on the poor, and supported by IDA (as well as by USAID). The programs had a twin objective: improving agricultural productivity and satisfying basic needs through health or education services (Staatz and Eicher 1978). Again, the state played the central role in delivering public goods as well as subsidized inputs, credit or extension services. In the aggregate, IRD programs were not successful. A well-known Bank publication of the 1970s reviewed 17 IRD projects in Africa and concluded that the main reasons were that they did not incorporate local technical expertise, emphasize local institutions, and understand the constraints faced by small farmers. Moreover, most projects were too costly to be sustainable beyond the pilot phase. Other factors that led to the disappointing performance of IRD programs were the urban bias of price policies, the lack of access to land and other assets and the lack of participation in the projects by beneficiaries.[47] The support for IRD—by both governments and major donors like the World Bank—decreased sharply in the early 1980s. These donors shifted their focus to extension, roads or education projects—which had previously been specific rural development areas and were now dealt with in isolation (Binswanger 1998). [48]

During the 1980s, rural development approaches also shifted toward more "market oriented" solutions and public interventions in rural areas diminished—in line with the neo-liberal belief that free-market forces would eliminate distortions and reduce poverty. But smallholders were falling behind: they were not in a position to adapt to the new market rules and the private provision of services could not easily replace their public provision due to information and market failures, in particular in credit and

[46] De Janvry, Sadoulet and Murgai 2002
[47] Uma Lele. 1975
[48] Hans Binswanger. 1998

insurance markets, preventing smallholders from adopting new technology and internalizing the benefits.

Today's understanding of rural development (embodied in part in the concept of "Community Driven Development") is that both market liberalization and strong institutions are essential. The role for the state is to strengthen property rights and legal institutions; supply public goods such as R&D for agriculture, basic education or rural roads; address the various risk faced by the vulnerable rural poor through targeted safety net policies; and invest in communication and information systems, support farmer associations, input or credit subsidies or extension services. Given the possible capture of policy benefits by rich rural élites, decentralizing governance and empowerment—to increase access to local information, mobilization of social capital for effective cooperation, participation in the decision-making process, and accountability of elected officials—might be important for successful rural development strategies.

Policy-Based Lending

The long boom of the 1960s came to an end in the early 1970s. Growth began slowing in many developing countries as policy induced distortions and inefficiencies took their toll. The shock inflicted by the oil crisis of 1973 was enough to precipitate a downturn by curtailing the demand for primary commodities and light manufactures from the industrialized countries, which were hard hit, and by sharply rising energy costs.[49] Growth and development slowed in many countries and went into reverse in some, with Sub-Saharan Africa being the worst affected not just by economic hardships, but also by a parallel upsurge in political turbulence and civil conflicts, exacerbated (or caused) by the rivalries of the superpowers locked in a lengthy "Cold War." Developing countries were subjected to severe external shocks. Increases in oil prices and grain prices, world-

49 The OPEC oil embargo combined with a depreciation of the US dollar led to the so-called "oil shock" of the seventies. In August 1971, the US had taken the US off the Gold Exchange Standard allowing the dollar to float and shortly thereafter, Britain and other industrialized nations followed suit with their respective currencies. In anticipation of the fluctuation of currencies, the industrialized nations also increased their reserves (printing money) in amounts far greater than ever before. The result was a depreciation of the value of the US dollar, as well as the other currencies of the world. Because oil was priced in dollars, this meant that oil producers were receiving less real income for the same price. The OPEC cartel communiqué stated that forthwith it would price a barrel of oil against gold.

wide inflation, high interest rates, floating exchange rates, low and unstable prices for all export commodities, and the interruption or reduction of commercial borrowing put an unprecedented strain on most developing economies. The recession experienced by those economies starting in 1979 was the most severe since the Second World War. Average growth rates of output were minuscule during 1979-1983. The performance was particularly bleak in 1983, above all in Africa and Latin America.

Adjustment lending emerged in the 1980s to fill a real need. First, adjustment loans were an attempt to move beyond individual projects. In a highly inflationary global environment, many developing countries suffered from macroeconomic instability and structural problems that undermined growth and made project assistance ineffective. Second, adjustment lending was aimed at helping countries undertake reforms and smooth the transition costs of adjusting to economic shocks. The impact of the deterioration in the terms of trade, the reduced foreign demand for exports, and international interest rate increases would be felt in the short run and the long run. External shocks directly affect national income by reducing demand, both demand for exports and domestic demand, and indirectly by reducing output below the capacity of the economy to produce because it is dependent on imported inputs for the purchase of which no foreign exchange is available. "Normal" corrective measures required foreign financing, and commercial banks were reluctant to increase their lending to developing countries. In the international architecture of the early 1980s, there were some mechanisms enabling governments to bridge the gap temporarily, but no internationally agreed-upon mechanism considers the case of permanent balance-of-payments difficulties. In this case, only painful adjustments can solve the problem. In the North-South world system, international mechanisms required the countries suffering from balance-of-payments deficits to operate the adjustments in their economies. The deficit of the South had its counterpart in the surplus of the North. In industrialized countries, which enjoy much higher standards of living, adjustments would be much less painful than in developing nations.

Between 1961 and 1981, a tenth of IDA’s lending (about US$2.9 billion) was not tied to any particular projects. These “program credits” could be disbursed rapidly and

were intended to ease severe foreign exchange constraints. They were accompanied by policy advice aimed at improving a country's overall performance.[50] They were generally linked to the industrialization program of the country. India received about half of the total for 11 industrial import programs. In the 1980s the program credits became much more systematic and the transfer of resources from IDA became more coordinated with International Monetary Fund (IMF) standby agreements. The intervention of the World Bank and the IMF was predicated on whether the shock was of a temporary or a permanent nature. If the shock resulting in balance-of-payments difficulties is temporary, so that sufficient external resources make it possible to keep both real consumption and real investment at their pre-shock level, there is traditionally a case for the IMF to make those resources available to the country until the situation reverses itself. If the shock permanently affects the terms on which the country interacts with the international economy, there is no presumption that finance will automatically be made available to ease the effects of these shocks. There are resources on which countries in difficulty can lay claim but the rule here is not automaticity but conditionality. The approval of the loan is made conditional on the acceptance by the country of a stabilization program to operate adjustments in the domestic economy, negotiated between the IMF staff and the economic policy team of the country, called a stand-by agreement.

Adjustments are required if previous projections concerning consumption, investment, and income level are to be realized in the medium to long run. Adjustment lending (and stand-by loans from the IMF) was mostly aimed at improving the macroeconomic conditions of a country through broad liberalization measures, with appropriate policies typically enforced through loan conditions. The focus on macro stability and drastic interventions was a response to the sorry state of many economies, which took on massive debts, thanks to recycled petrodollars, and continued to spend as they had in the commodities boom of the 1970s.

The results generated by adjustment lending were mixed. On the one hand, there was an improvement in developing countries' policies. Better macroeconomic policies and greater openness have improved the economic environments of these countries.

[50] IDA in Retrospect (1982), p. 54

Inflation, which typically does the greatest harm to poor people, fell significantly during the 1990s; at the same time, macroeconomic management improved, exchange rates were more stable, and trade barriers were reduced. But there was little progress in governance, controlling corruption, and quality of institutions worldwide—as measured by the governance component of the World Bank's CPIA index—although there is significant variation across countries. On the other hand, adjustment was, by and large, a failure in terms of growth. As shown by Easterly (1985), none of the top 20 recipients of repeated adjustment lending over 1980-99 were able to achieve reasonable growth and contain all policy distortions. About half of the adjustment loan recipients showed severe macroeconomic distortions regardless of cumulative adjustment loans. Econometric tests fail to show that adjustment lending has any positive effect on policies or growth. [51] This is also a conclusion reached by several internal OPCS reports. [52]

Thus, despite good intentions, the record of adjustment lending by IDA (and by IBRD and the IMF) in the 1980s and 1990s is mixed at best. To be sure, it includes a number of success stories. But it also includes cases where adjustment programs were misguided or not followed. First, heavy reliance on conditionality was usually ineffective, with the large number of conditions doing nothing to strengthen borrower ownership of the reforms. Second, while the focus on improving poor policies was understandable, the design of adjustment programs paid inadequate attention to governance and institutional problems, which were major constraints on the investment climate. Finally, there was too little emphasis on equity issues and mitigating the social costs of adjustment. This was probably because many of the poor policies that adjustment lending targeted were both inefficient and biased against poor people. Nevertheless, the lack of specific attention to poverty issues led to progress involving damage to poor people and understandably attracted heavy criticism.

Although conditionality can support policy changes, it cannot persuade reluctant reformers. The number and frequency of conditions attached to adjustment loans and

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[51] William Easterly 2005

[52] See Adjustment Lending Retrospective, June 15, 2001; Review of World Bank Conditionality, September 2005; Conditionality in Development Policy Lending, November 15, 2007, and 2009 Development Policy Lending Retrospective, October 27, 2009

standby agreements from international financial institutions have little to do with whether policies are reformed. Case studies have shown that effective policy reform generally emerges from domestic political consensus—and conditionality from donors does not help, and sometimes hurts, consensus building. There can be exceptions in the cases of ‘‘stroke-of-the-pen’’ reforms (such as exchange rate adjustments), where only a small number of decision makers need to be convinced of the benefits of a policy change. But even in these cases, policy reforms risk reversal if they do not command broad support.

The World Bank use of conditions has fallen significantly since the late 1980s, and the content of conditionality has shifted from short-term economic adjustments to institutional reforms in social sectors and public sector governance (World Bank, 2005 and 2007).[53] The World Bank (as well as the IMF) reduced the number of conditions attached to their loans to developing countries—while it increased the emphasis on “country ownership [of its policy reforms]” and jointly monitorable results. Development policy lending replaced adjustment lending in 2004. The overhaul reflected the need for streamlining conditionality and the Bank's acknowledgement that there is no single blueprint for reform that will work in all countries. The shift by donors toward ex post conditionality—that is, aid based on jointly monitored results rather than promises—is a simple recognition of what they have learned from the political economy of reform, especially in former socialist economies in transition.[54] Domestic ownership (and domestic leadership) is essential. Successful reforms are those where government officials know what they want. They would carry out the reform with or without donors.

Governance

In the 1980s, development approaches stressed improving policy, particularly in macroeconomics and trade, and “getting prices right” by removing government-imposed barriers to markets. The end of the Cold War—which meant that dictatorial regimes did not need to be supported politically and economically for foreign policy reasons—opened

[53] World Bank 2005 and World Bank 2007

[54] On this, see the 1996 World Development Report, From Plan to Market, led by Alan Gelb and the references cited therein (World Bank 1996).

up the discussion of governance. This coincided with new research on institutions, and gradually there was a shift in much of the policy content of IDA operations toward governance in Public Expenditure Reviews and Public Sector Reform Credits. The interest in institutions and governance was awakened for four reasons.

First, the failure of structural adjustment programs to spark growth in many low-income countries in the 1980s focused attention on the role of institutions and governance in development.

Second, and perhaps most important, the end of the Cold War removed self-imposed blinders from the eyes of donor countries. Until the early 1990s, the United States and its allies had refrained from scrutinizing the governance failings of proxy states, for fear of undermining what they saw as the bulwark against communist expansion. But with the demise of the Soviet Union, both developed-country donors and developing-country citizens decried poor governance as a hindrance to development.

Third, the transition in the economies of Eastern Europe and former Soviet Union in the early and mid-1990s—which was far more difficult than many observers had expected—underlined the great importance of the institutional foundations for markets and good policy.

Fourth, the East Asian financial crisis of 1997–98 showed that even where policies had supported rapid growth and poverty reduction, weaknesses in institutional and governance foundations could threaten the whole edifice of development progress.

In the literature there was increasing evidence linking dismal growth and poverty to corruption, waste, and authoritarian practices in government. For example, in a survey of more than a century of comparative development experience in 40 developing countries, Reynolds (1983) wrote that "the single most important explanatory variable [of development] is political organization and the administrative competence of government."[55] The contributions, in economic theory, of Douglass North and Oliver Williamson, and the literature on reform and political economy gave this new field a solid basis.[56]

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[55] Quoted in Lin and Nugent (1995), p.2333.
[56] See Dethier (1999)

The core idea behind this new thinking about institutions and governance is as follows. Institutions, laws and decisions made by public officials — policies and regulations — define incentives for economic agents and affect the allocation of investment and public expenditure. Of the total GDP produced by a country, part is used for government expenditure. From total GDP produced by the private sector, subtract public expenditure to obtain net potential production. It is potential because of deadweight welfare losses created by taxation and rents. The resources available to government from taxation or public borrowing are used for the provision of public goods or for redistribution (transfers), or are siphoned off in the form of rents captured by agents exploiting a monopolistic position (information or discretionary power). The ”cost of government,” including the cost of enforcing rights, is a function of the deadweight losses created by taxation and rents, the costs of providing public goods (costs which should be measured in terms of outcomes such as illiteracy, infant mortality, schooling achievements, or quality of infrastructure) and transfers, and the productivity of transfers. Governments play an essential role in facilitating, or hindering, the growth of output in several ways, for example by improving inputs such as human capital or by increasing, through the creation of new institutions, the efficiency with which inputs are used. Government is partly endogenous to the process of economic growth.

Hirschmann (1970) showed that governments are principally disciplined by the exercise of voice, while markets create managerial discipline and induce efficiency through the exercise of choice. Consumers can choose not to consume; shareholders can sell their shares, but citizens’ options with regard to public goods are more limited. Citizen preferences are not linked to taxes or revenue for public services because taxation is ultimately coercive. Government performance is induced through other channels than is market performance, including accountability, transparency, and the rule of law (Brautigam, 1992). Under given historical circumstances, informational, transactional and political constraints on government activity can lead to the creation of efficient (or inefficient) incentive schemes and institutions that produce welfare increasing (decreasing) outcomes.

Wealthy economies developed under a variety of policy regimes, from fairly liberal (Taiwan, China or the United States) to fairly statist (Japan, Sweden). But they all passed a threshold of institutional quality that ensured political and economic stability, reasonable state capacity, enforcement of property rights and contracts, sufficient provision of public goods, and limits on government predation and corruption. In contrast, many countries with poor institutions and weak governance are beset by poorly designed and weakly implemented policies, shoddy infrastructure and public services, and state harassment of citizens and business. Legal systems are neither effective nor predictable. Contracts are only weakly enforceable. And crime is widespread. Police extract money from citizens they are supposed to protect. Public officials steal public funds rather than provide public goods. They distribute contracts, licenses, and jobs to their friends and political supporters—or sell them outright. And they demand bribes for services, denying the neediest. The transition to capitalism in China is the more fascinating, and still somewhat contested, story.[57] Most people will agree that, while the Chinese Communist Party retains the monopoly of power, much of the economy is no longer a command economy, with the market mechanism being the major allocator of resources. About 95 percent of consumer prices are now market-determined, although the state still controls prices in some key sectors (like financial services, telecoms, utilities and energy). But is the economy primarily capitalist now, with private owners of capital providing the dominant mode of organizing social and economic life through their drive for profit-making and accumulation? The answer is still somewhat ambiguous. It is not easy to classify Chinese firms by their ownership or to distinguish between private control rights and other forms of public or semi-public control rights or to trace their varying shares in a firm. Some evidence suggests that the private sector now contributes more than half of industrial value added (although not of fixed capital investments). The convoluted nature of private ownership is, of course, part of the legacy of the development of the Chinese private sector under the shadow of the state. As late as 1988, private firms with more than 8 employees were not permitted. Many private firms operated below the radar and used various subterfuges and covert deals with local

[57] See De Melo, Denizer, Gelb and Tenev (1997) and Bardhan (2010)

officials, as they adapted themselves to the changing permissible mores. Some of them used to be called “red-hat capitalists,” sometimes hiding under the façade of local collectives. Many of the smaller and regional state-owned enterprises (SOEs) were privatized and often their managers became the new owners. Currently about one-third of the private entrepreneurs are members of the Party (including *xiahai* entrepreneurs who are former officials); membership helps them to get state finance, and more protection and legitimacy. Of course, it is well-known that many of the entrepreneurs are in fact friends or relatives of Party officials. Many SOEs are controlled by powerful political families. One of China’s most respected economists, Jinglian Wu, has described all this as “crony capitalism.” There is a new political-managerial class that, over the last two decades, has converted their positions of authority into wealth and power. The vibrancy of entrepreneurial ambitions combined with the arbitrariness of power in an authoritarian state has sometimes given rise to particularly corrupt or predatory forms of capitalism, unencumbered by the restraints of civil society institutions. The state is still predominant in the producer goods sectors and in transportation and finance. The state still controls the larger and often more profitable (high-margin, more monopolistic) companies in the industrial and service sectors. Some of the SOEs are now important players in the global market competition. They are often highly commercialized: in recruiting professional managers, broadening their investor base, and shedding their traditional social and political obligations, many SOEs do not conform to the usual stereotypes. Nevertheless, it is probably correct to say that, while the Party can undo individual capitalists at short notice, it will be much more difficult for the leadership to unravel a whole network of capitalist relations, by now thickly overlaid with various vested interests and knotted with *guanxi* ties. Individual entrepreneurs have a clientelistic relationship with the state, but the state, for all its relative autonomy, is now sufficiently enmeshed in a profit-oriented system that has been identified with legitimacy-enhancing international economic prowess and nationalist glory, a tiger that the political leadership may find difficult to dismount. Even at the local level, the central leadership finds it difficult to rein in its own local officials who in collusion with local business commit some of the worst capitalist excesses (in land acquisitions, product safety violations or toxic pollution).

Weak institutions are not only an inequitable burden on citizens—they also act as a brake on economic growth by undermining incentives in the private sector. Businesses in poor countries face much larger regulatory burdens than those in rich countries. They face three times the administrative costs, and nearly twice as many bureaucratic procedures and longer delays. And they have fewer than half the protections of property rights of rich countries. Most of these failings do not show up on standard macroeconomic measures of performance, yet they are inimical to development. Societies with weak institutions have not developed the basis for complex economic interactions; they have neither the software nor the hardware for development. The result is dysfunctional markets, weak competitive pressures, and private sectors dependent on government cronyism and corruption. Incentives are misaligned, so that entrepreneurial individuals "invest" their time and resources in competing for rents from the political system. Social norms form around clientelism, rent-seeking, and factional competition, rather than social cohesion and progress. These destructive norms become rational for the individual, despite their negative collective effect, and they often prove difficult to unravel.

The breakdown in governance, erosion of institutions, and collapse of social cohesion are typically associated with a radical decline in living standards and rise in inequality—as experienced by low-income countries. Heavy regulation and weak property rights exclude the poor from doing business.

The institutions of developed economies vary greatly, whether in regulation, social protection or labor markets. Even the meta-institution of democratic governance does not have unambiguous effects. The formal institutions of democracy do not always ensure checks on weak governance. Nor are these checks always absent in authoritarian regimes. Contrasting experiences in less democratic East Asian countries in the 1970s and more democratic African ones in the 1990s illustrate that mechanisms of accountability can take varying forms, defying a simple classification of formal political institutions. Not only are successful institutions highly varied in structure, but their origins are complex as well. Institutions are highly endogenous: they are not easily manipulated by governments as exogenous levers, but instead arise and evolve in historical contexts. These factors make the analysis of institutions a great challenge, one

that development studies have just begun to grapple with seriously. But the recognition of the central role of institutions and governance itself marks a major advance in development thinking.

How IDA views governance has evolved and new types of analytical reports and studies have been produced. This has improved the quality of its lending as measured by the ratings of the Independent Evaluation Group (IEG) of the World Bank. The traditional Public Expenditure Reviews done by Bank/IDA staff have been expanded to include institutional issues, such as the policy formulation process, independence of national audit offices, and detailed assessments such as Country Procurement Assessment Review (CPAR) and Country Financial Accountability Assessment (CFAA) have become "core diagnostic" work for IDA.[58] In some cases IDA undertook governance reviews and these have influenced IDA's project preparation process. IDA has also teamed up with other development partners in the preparation of Public Expenditure Framework Assessments (PEFA), a benchmarking exercise for public resource and budget management that is comparable across countries. At the same time, this line of work has shown that understanding how governance related processes and reforms worked is far from complete. New research has also pointed out the importance of legal frameworks and enforcement issues for which IDA has no direct instruments. As noted by Deaton, "reforming governance and institutions is a much taller order than building a water delivery system or even a petrochemical plant." Indeed governance-related reforms are frontier areas for IDA and successful transitions to sound governance would need to originate from within countries. Outside expertise can only play a supportive role.

Rise of Governance Lending. Part of this was the shift in the nature of non-project finance from policy conditionality toward governance-related measures. These constituted about half of all conditions in Poverty Reduction Support Credits (PRSCs).

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[58] During the 2000s, IDA required a "minimum package" of economic reporting for IDA countries ESW, including PERs and CFAAs. The CFAA was formally designated as an economic and sector work (ESW) product of the World Bank in July 2000 (see CFAA guidelines 2003). This caused an increase in the share of budget-related and fiduciary work. The fact that some IDA countries were also Highly Indebted (HIPC) countries also played a role in this increase since donors wanted to know where the debt relief was going.

Projects supported by IDA are now required to carry out national poverty-reduction strategies. The Comprehensive Development Framework (CDF), which governs the development of these strategies, was presented to the World Bank Board of Governors in 1998. The framework spells out four principles, all of which mark significant shifts in thinking about development since the 1990s:

- *Development strategies should be comprehensive and shaped by a long-term vision.* In the past, development strategies emphasized short-term macroeconomic stabilization and balance-of-payments corrections. The CDF stresses longer-term structural and social considerations, such as expanding and improving education and health facilities, maintaining infrastructure, and training a new generation of public officials.
- *Each country should devise and direct its own development agenda based on citizen participation.* The CDF holds that when countries "own" reforms, governments and their citizens are more committed to seeing them through.
- *Governments, donors, civil society, the private sector and other stakeholders should work together in partnership led by recipient countries to carry out development strategies.* Partnerships built on transparency, mutual trust and consultation can increase the efficiency and effectiveness of aid, and help countries increase their capacity to develop and carry out a wide variety of programs.
- *Development performance should be evaluated on the basis of measurable results.* Traditionally, the Bank tended to concentrate on disbursement levels and project inputs in evaluating development efforts, an approach that measured only resource allocation and consumption. The CDF emphasizes that evaluation should focus on the impact of aid on people and their needs.

In 2001, the boards of the World Bank and the IMF adopted the Poverty Reduction Strategy process (PRSP). This process became the basic springboard for all low-income country access to expanded debt relief, and then to the concessional funding windows of the two institutions – the International Development Association (IDA) and the IMF's Poverty Reduction and Growth Facility (PRGF). The PRSP proved to be a helpful vehicle for integrating development efforts across sectors and development partners. As a result, some major bilateral donors shifted from stand-alone projects toward multiyear, multi-donor projects and programs with the flexibility to direct

resources toward reforms across a significant part of the economy. The process is hailed as an advance on previous aid-delivery mechanisms for three reasons.

First, it is supposed to be country owned. Each strategy is developed by the government of the recipient country and the Poverty Reduction Strategy Paper is discussed by political parties and major groups in society through a participatory process.

Second, it is supposed to be a vehicle for coordination and harmonization among donors and reduces the costs of donor fragmentation. The World Bank, the IMF and the main donors (EU Commission, DfID, etc.) support the PRSP. In many countries, the PRS process has become the main forum for donor coordination.

Finally, it provides aid with a consistent policy framework and represents a move away from project-based assistance. Countries that have a demonstrated track record of serious economic reforms receive aid in the form of direct budget support (through Poverty Reduction Support Credits and the like). To provide accountability, the PRSP identifies clear targets for results and monitors progress toward them. The PRSP process, while continuing the tradition of structural adjustment, represents a move away from excessive conditionality. As of 2007, 62 countries had implemented PRSPs (or interim PRSPs) and a third of those were on their second PRSPs. Some 21 fragile states have had PRSPs (4 had a PRS-II, 10 a PRS-I, and 7 had an Interim PRS).

Because of selectivity, IDA assistance is more focused on "willing reformers" articulating a development vision through the PRS process (poor countries with relatively good institutions and policies) and donors have attempted to lighten conditionality and mainly support measures included in the country's PRSP.[59] The change to a more country-owned process has not been trivial. There is a difference between a voluntary, country-owned statement of priorities (the PRSP) and a mandatory, externally driven judgment about its quality and feasibility (Rogerson et al 2004). The two are notionally separate—the government "owns" its strategy and the donors "own" their independent assessments of the strategy and resulting aid allocations—even if, in practice, different

[59] In the IMF's PRGF also, conditionality has become more parsimonious, focused on the Fund's core areas of expertise, and limited to measures that have a direct and critical impact on the program's macroeconomic objectives.

power relationships and local chemistry determine how much one actually influences the other. It is too soon to evaluate this evolution in the way of delivering aid.

Can conditionality be avoided? As long as a transaction has a lender and a borrower, it is inevitable.[60] It may be implicit or explicit, narrow or expansive, but it cannot be wished away. Still, conditionality as it was applied in the 1980s and 1990s was excessive and failed to deliver results. Are there alternatives? Greater emphasis on country ownership of programs as envisaged in the PRSP process and peer-monitoring mechanisms like the New Partnership for Africa's Development (NEPAD) are steps in the right direction. It is also important that there be a separation of powers between the agencies that lend money and impose conditions and those that monitor compliance. As long as the actions of lenders separate risks from (political and financial) rewards, they will induce a "conditionality moral hazard." Conditionalities are incomplete contracts and there are inherent limitations to what the instrument can achieve. Kapur (2004) suggests as a drastic change to institute broad ranging risk sharing contracts between individual poor countries and rich countries, mediated through IDA and other international financial institutions. What is needed is a strategy based on an explicit typology of developing countries (Temple 2010). Bourguignon and Sundberg (2007) argue that current policies increasingly amount to a three-track model. Countries with good governance and policies receive budget support; intermediate countries face something more like traditional conditionality, but with greater emphasis on governance and performance; and fragile states are aided through a combination of humanitarian assistance and aid that bypasses the state, for example, by allocation to NGOs.[61]

Balance of payments support was mentioned as a motivation for program lending in the early 1980s. Increasingly, in the 2000s, budget support has been mentioned as a motivation. Budget support is a method of financing a developing country's budget through a transfer of non-earmarked resources from IDA (or other donor agencies) to the recipient government's national treasury. This is contrasted with project approaches in which aid is tied to the creation of discrete development projects or provision of specific

[60] Kapur, Devesh. 2004. "Conditionality and its Alternatives." In Inge Kaul and Pedro Conceição, eds., *Public Finance in a Globalizing World*. New York: Oxford University Press.

[61] See also Temple (2010) and Koeberle et al. (2005)

technical assistance services, often undertaken outside regular budgetary systems. It is a direct consequence of the findings from the economic literature concerning fungibility.

The share of budget support in total aid commitments is around 5-7 percent of total ODA today. By contrast, sector program support (i.e., aid contributions to a defined sector such as agriculture, education or transport) has increased greatly—nearly tripling between 2003 and 2004. Low-income countries received the lion's share (63 percent) of total general budget and sector program support, two examples of fast-disbursing aid. And, during 2001-2004, low-income countries were the main beneficiaries of commitments for debt relief, which from a macroeconomic point of view is akin to fast-disbursing ODA.[62]

Table 1. ODA for Sector Programs, General Budget Support and Debt Relief
(Commitments, US$ million at 2004 prices, 2001-2004)

Type	US$ amounts (2004 prices)				% of total commitments			
	2001	2002	2003	2004	2001	2002	2003	2004
Sector Programs [(1)]	***641***	***1,984***	***5,404***	***14,666***	***1%***	***2%***	***6%***	***15%***
Low Income	199	774	1,591	7,854	0%	1%	2%	8%
Middle Income	441	1,105	3,645	6,011	1%	1%	4%	6%
Unallocated	0	105	168	800	0%	0%	0%	1%
General Budget Support	***4,847***	***5,850***	***6,395***	***5,249***	***7%***	***7%***	***7%***	***5%***
Low Income	3,919	4,853	3,635	4,631	5%	6%	4%	5%
Middle Income	913	990	2,745	608	1%	1%	3%	1%
Unallocated	14	8	16	11	0%	0%	0%	0%
Total General and Sector Support	**5,488**	**7,834**	**11,799**	**19,915**	**8%**	**10%**	**12%**	**20%**
Debt relief	***5,582***	***8,504***	***17,778***	***8,570***	***8%***	***10%***	***18%***	***9%***
Low Income	2,962	5,263	14,771	7,578	4%	6%	15%	8%
Middle Income	2,601	3,102	3,003	899	4%	4%	3%	1%
Unallocated	19	139	4	93	0%	0%	0%	0%

(1) Excluding debt relief and general budget support to avoide double counting. Only commitments with no investment or TC components.

Impact Evaluation and Focus on Results

Measuring the effectiveness of IDA projects and programs means collecting evidence about which policies really work in a given economic, social and political setting. Although earlier the success of IDA operations was measured in terms of rates of return on projects, increasingly results are measured using impact evaluation methods. "Donors are shooting in the dark because they refuse to collect solid evidence on what works," says Angus Deaton. Researchers both in academia and at the World Bank have increasingly been focusing on impact evaluations to complement more traditional

[62] See Development Committee, "Aid Architecture: an Overview of the Main Trends in Official Development Assistance Flows." Document DC2007-0003, March 29, 2007

assessments. This line of research has revived the issue of the "micro-macro paradox." In a famous paper, Mosley (1987) suggested that, while foreign aid seemed to be effective at the microeconomic level, its aggregate or macro impact was much more difficult to identify. Indeed, analyses of the impact of aid on growth based on cross-country regressions produce mixed results but there is evidence that multilaterals and bilateral donors have successfully implemented individual projects. Thus the "micro-macro debate" continues. The consensus among researchers is now that macro and cross-country level results should be complemented by micro impact evaluation studies to yield a balanced assessment. Taking this approach, for example, Arndt, Jones, and Tarp (2010) find that aid has a positive and significant but moderate effect on growth.

Impact evaluation differs from the internal evaluation efforts carried out at the World Bank by various units, including QAG (quality at entry) and IEG (ex post evaluation). While the latter evaluate processes, assess whether projects have reached their intended objectives and document changes in specific outcomes, impact evaluations (carried out in the Research Department or other units of the Bank, or in universities around the world) evaluate the development impact of a project on its target population (e.g., on poverty or health outcomes) by comparing the observed outcomes to a counterfactual (i.e., what the situation would have been if the program had not been undertaken). Impact evaluations are a scientific means of establishing causal links between interventions and outcomes and constitute a key input to determining cost-effective approaches to development. Aid would become much more effective if projects took into consideration the results of studies based on such rigorous methods.

IDA has gradually changed its approach to measurement from measuring inputs used for development projects to measuring outcomes, i.e., from public resources spent on inputs to outcome indicators (such as illiteracy rates, morbidity, infant mortality, school achievements, infrastructure characteristics, etc.). One reason is easily understandable: since governments do not spend money equally effectively, these numbers per se tell us nothing about government efficiency. Since the incentives to improve the quality and reduce the cost of public goods are stronger for private providers than for public ones, it is necessary to have data on both the quality and the quantity of output in order to compare public and private activities. Quality characteristics can be

handled in a qualitative dependent-variable framework, but some attributes such as effort may not be directly observable.

As observed on many occasions and, more recently in the report of the Sen, Stiglitz, Fitoussi Commission created by President Sarkozy, although it is possible to measure physical productivity (output per unit of physical input) in relation to private goods, measuring productivity in relation to many public goods and to services provided by the public sector remains a challenge (Stiglitz, Sen and Fitoussi 2009). We might find comparative data on the wages and labor needed to produce private and public goods, but what number of employees is appropriate for the production and provision of collective services, such as defense, maintenance of law and order, legislation and regulation, etc.? Since this problem is difficult to resolve, public sector accounts are based, in value terms, on the assumption that "the value of the final consumption of general government is taken to be equal to the value of the expenditures they incur on collective services" (UN 1993, paragraph 9.91, p.215).[63]

Development is now almost universally synonymous with poverty reduction, and absolute poverty is recognized as the inability to achieve basic standards in nutrition, health, education, environment, and a voice in the decisions affecting poor people's lives. The *2000/2001 World Development Report* articulates the multifaceted dimensions of poverty, emphasizing that social development carries intrinsic value in addition to whatever instrumental value it may have. Signaling this recognition, the Millennium Development Goals (MDGs) were adopted in 2000 at the United Nations by the representatives of 191 countries. They commit the development community to work toward progress in the multiple dimensions of poverty reduction.

IDA is now much more focused on achieving the desired results in terms of poverty reduction than on inputs (measuring "success" in terms of dollars or bags of wheat given to the government). But the systematic measurement of outcomes raises a number of methodological and practical questions that are still not resolved.

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[63] A problem arises when measuring outcomes that are unobservable, e.g., improvements in governance. Proxies are used in the governance literature, including in the now famous governance index constructed by Kraay and Kaufmann—either quantitative proxies (e.g. the number of changes in government as a gauge of 'political instability') or qualitative variables (e.g. the subjective ranking of contract enforcement as a gauge of 'institutional efficiency').

First, there is the question of which metrics to use. For example, the kind of multidimensional picture of poverty found in the Millennium Development Goals is probably preferable than a one-dimensional measure like "$1 a day poverty" but it raises evaluation issues. MDGs were "decreed from above," using the same goal for all countries regardless of their initial conditions, and not "from below" starting from what is achievable in each country. As Clemens, Kenny and Moss (2004) have correctly pointed out, the fact that most MDGs will not be achieved by 2015 in low-income countries should not obscure the fact that development has progressed at unprecedented levels over the past 30 or more years. Thus, the MDGs create an unnecessary pessimism by labeling many development successes as failures. For example, in many IDA countries, the rates of progress required to meet the education and health MDGs are extremely high compared with the historical experience of the West. And the costing has never been done properly. There is no relationship between the desired outcomes and their cost—not to mention who should pay for these expenditures: the local population (domestic taxes) or aid (foreign taxes).

Second, there is the issue of methodology. An impact evaluation is an assessment of the performance of a program in attaining well-defined objectives against an explicit counterfactual, which is the absence of the program. It amounts to making causal inferences, answering a question of the type "How would participants in a given project/program have fared in the absence of the program?" Comparing the same individual over time will not, in most cases, give a reliable estimate of the program's impact since other factors that affect outcomes may have changed since the program was introduced. We cannot obtain an estimate of the impact of the program on a given individual but we can obtain the average impact of a policy or program on a group of individuals by comparing them with a similar group of individuals who were not exposed to the program. Purists will find that impact evaluation must be done through randomized evaluation (or at least using quasi-experimental methods).

Programs are placed in specific areas (for example, poorer or richer areas). Individuals are screened for participation (for example, means tested) and the decision to participate in a program is often voluntary, creating self-selection. For all of these reasons, those who were not exposed to a treatment are often a poor comparison group

for those who were. Any difference between the groups can be attributed to both the impact of the program, called the *treatment*, and pre-existing differences, called the *selection bias*. Without a reliable way to estimate the size of this selection bias, the analyst cannot decompose the overall difference into a treatment effect and a bias term. The selection bias can be entirely eliminated when individuals or groups are randomly assigned to the treatment group and the comparison group. But most evaluations of aid projects are not randomized.

In practice, organizations like IDA that routinely evaluate ex post the outcome of their projects use rather coarse methodologies that simply compare average outcomes between units that have the project (water and sanitation; feeder roads; schools, etc.) and those that do not in order to assess the impact of the change. But failure to control for differences in the pre-intervention characteristics of the participants and nonparticipants could severely bias such comparisons. Randomization can be a powerful tool to assess the impact of policies/interventions but, as Ravallion (2005) notes, it is neither necessary nor sufficient for a good evaluation—nor is it always feasible, notably for large public programs. Non-experimental econometric methods can be used instead of pure randomization. They exhibit biases but, with adequate data, they can produce excellent results that can be very useful for policy makers and other practitioners. Many well-known evaluations carried out in developing countries use non-experimental econometric methods.[64] They provide useful results that can be used by donors. They demonstrate that aid can greatly benefit from serious studies applying rigorous econometric techniques to evidence collected in the field. [65]

Good methodology is not sufficient to produce good results. A good evaluation requires an important involvement of the evaluator so that he/she understands well the design of the program, the context in which it is applied and how the program works on the ground. Moreover, not all policies/programs and development issues are susceptible to being evaluated. Some development practices are susceptible to impact evaluation: generally speaking, human development policies (education, health or social policies;

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[64] See for example, Glewwe, Kremer, Moulin and Zitzewitz (2004), Galasso and Ravallion (2005), Duflo and Pande (2005), Galiani, Gertler and Schargrodsky (2005), or Olken (2005).

[65] For references to this literature, see the websites of the World Bank's Poverty Net Impact Evaluation and Development Impact Evaluation Initiative at http:/www.econ.worlbank.org

environmental policies; taxation policies; etc. that have fairly well-defined target populations). Other development practices—for example, public finance management reforms—that potentially have huge payoffs may be extraordinarily high.[66] Even when policies are susceptible to impact evaluation, there are many concerns—both ethical and technical—about both the internal and the external validity of what research can unearth. Randomized evaluations, being "social experiments," raise serious ethical concerns. Review boards, first created in 1974, were initially restricted to biomedical research. In 1981 the regulations were revised to cover all research that involves human subjects and is designed to contribute to "generalizable" knowledge.

We need to distinguish here between internal validity and external validity of impact evaluations. Issues of internal validity are concerned with the methodology of the experiment. Does the design allow us to obtain a reliable estimate of the counterfactual outcomes in the specific context? Issues of external validity are whether the results from a specific evaluation can be replicated in other places and periods.

Developing countries have learned useful lessons from the policy advice given by IDA. Some policy lessons can be transplanted from rich to poor countries. To an extent, this is what successful East Asian countries have done—they have imported and adapted to local circumstances administrative practices and legal institutions, in some cases with assistance from IDA and other donors.[67] It is possible to transplant policy rules and regularities from one context to the next—so that we don't have to reinvent the wheel every time we advise a different government—because we can expect some behaviors to be universal. We know, for example, that food consumption will increase at low levels of

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[66] The crucial element to coordinate the strategies of different ministries within government, as well as to align the aid strategies of the various donors with the overall strategy of the government is the budget. The failure to link policy, planning and budgeting is the single most important cause of poor budgeting outcomes in developing countries. See the IMF website on Public Financial Management http://blog-pfm.imf.org/pfmblog/2008/01/france-improvin.html.

[67] Pistor and Wellons (1998) discuss changes in legal institutions in Asian countries over 1960-1995. East Asian countries transplanted parts of Western law (competition law, environmental and consumer protection, intellectual property rights, securities and exchange regulations, etc) in response to specific crises (environmental disasters, misuse of monopoly power, etc.), often under political and/or financial pressure from foreigners. The economic "take-off" of the tiger countries went hand-in-hand with a strengthened role of the state, and legal change preceded the economic outcomes. During the 1980s, policy changes prompted economic change which, in turn, gave rise to the demand for new legislation, and the repealing of numerous laws shifted control rights from the state to the market.

income if income increases. We can use this “wisdom” as our prior until we have evidence that it is not the case in certain circumstances. Some human behavior is universal and imprinted in the genes of all humanity but other types of behavior are culturally determined. Therefore some behavioral responses to a particular program or policy will not be the same. For instance, it is not clear that one can draw lessons from the Latin American experience with conditional cash transfers (there are CCT programs in almost every country) that are relevant for, say, rural Africa.

The political dimension of policy is also important. An evaluation should be able, at the very least, to distinguish between gainers and losers. For example, Lanjouw and Ravallion (1998) estimate the marginal odds for individuals of different income categories to participate in school and anti-poverty programs, using 1993-94 National Sample Survey data from rural India. Their results suggest that the benefits of these programs are captured early on by the non-poor. The lack of fiscal discipline (called the “soft budget constraint” by János Kornai) is an economic issue with political roots that is prevalent around the world. It makes public expenditure management and macroeconomic control particularly difficult, because the state must be able to resist the pressure of interest groups, and greatly complicates the process of reforming governance. For example, there are enormous pressures to increase local expenditures to counteract growing unemployment and the closure of loss-making enterprises, not to mention other kinds of subsidies to friends and cronies. Such pressures can create problems in restoring fiscal discipline at the macroeconomic level.

It is important to understand the heterogeneity of the impact of the program on various population groups. This is very relevant for the political economy of anti-poverty policies, or for privatization and restructuring of enterprises, since it may indicate the need for supplementary policies for better protecting the losers. For example, the foregone labor earnings incurred by participants in workfare or conditional cash transfer schemes (via the loss of earnings from child labor) will vary according to skills and local labor-market conditions. Heterogeneity of impacts in terms of observables is readily allowed for by adding interaction effects with the treatment dummy variable (Ravallion 2005).

Carrying out evaluations across different settings and at different scales can throw light on what influences the outcomes, whether it is politics, the behavior of elites, the capacity of local or national governments, or the presence or absence of social capital. [68] This is the objective of the DIME initiative of the World Bank, which includes many IDA-financed projects. It is also essential to take into account positive or negative externalities of the project. A form of externality that is frequent is the fact that many donors often hire the best and most capable administrators away from their government jobs (where social returns to their labor are higher) to work in their PIU (project implementation unit). The extreme form of spillover effect is an economy-wide program—for which classic impact evaluation tools are inadequate since no explicit assignment process is evident and externalities are pervasive (Ravallion, 2005).

Last but not least, when careful impact evaluation demonstrates that a particular policy is helpful for developing countries, the main problem is replication. Even if the evaluation is externally valid so that, if replicated in other places and periods, similar results could be obtained, the issue is the practice of development by bilateral and multilateral donors that have a tendency to be subject to fashions and to produce development projects like sausages.

Conclusions

From this assessment of the influence of ideas on IDA operations, we can draw at least four useful conclusions.

The World Bank, because of its organizational structure, which allows its staff to learn from its projects and policies (e.g., the presence of an ex post evaluation group drawing lessons from its activities), and because it has nurtured a cadre of good researchers, has been a major contributor to development economics through data, research and by fostering interactions between operational staff, policymakers and

[68] Deaton (in Banerjee ed., 2007) writes that some types of evidence may not be useful outside of very specific circumstances. He cites as an example the famous *Worms* paper of Miguel and Kremer (2004) saying that "the results of one experiment in Kenya (in which there was in fact no randomization, only selection based on alphabetical order) hardly prove that de-worming is always the cheapest way to get kids into school" since the rate of re-infection depends on whether children wear shoes and whether they have access to toilets.

researchers. There have always been close connections between IDA and researchers interested in development economics. At least since the early 1970s, research on development has been informed by practice and, with continuous feedback from evaluation, IDA has been a learning institution. The operations prepared by IDA staff have integrated lessons and findings from research. It is doubtful whether, without the influence of research and the close connections between research, policy advice and policy practice, IDA would have become a premier development organization.

The World Bank has been a pioneer in the measurement of poverty and has conducted many surveys (household surveys or health and demography surveys). Many advances, such as poverty mapping and research on equity, also originate with the World Bank. Research at the World Bank—with its close links with academia around the world—has been the interface and intermediary between cutting edge intellectual advances and informed operations. The Bank's research staff—the quality of which, over the years, is attested by its rankings and citation counts—has excelled at publishing relevant research and helped their colleagues in other departments by participating in IDA/Bank operations.

The allocation of IDA funds is an important area that has been influenced by changes in development thinking. First, the dominant thinking on development has influenced IDA in terms of sector priorities, putting emphasis first on infrastructure and increasingly on agriculture, then in the 1980s on macroeconomic adjustment and policy reform, and finally in the 1990s on governance and institutional factors.

Second, starting in the late 1980s, IDA assistance became less determined by political considerations and more subject to selectivity, i.e., the idea that assistance would have a greater impact on poverty reduction if it were focused on countries with stronger economic institutions and policies. The formula now used by IDA attempts to balance needs and performance, and gives a lot of weight to governance. Governance and institutions—increasingly viewed by economists as one of the major causes of underdevelopment—represent a real challenge for IDA, and it is not clear how much can be achieved. In the absence of direct instruments to reduce poverty, the Bank has sought to understand the institutional constraints blocking development governance through its PERs, PEIRs, CFAA, CPARs, governance reviews, and PEFAs, and has developed

benchmarks that enable governments to make progress in their country along various dimensions of policy and governance.

Third, there is a great divergence of outcomes across IDA countries and, in some of the countries, reforms have moved slowly—which is not surprising when one considers that it took European countries many years to become modern states. The main reason is that reform policy choices are not exogenous. They depend on both initial conditions and political reform, with political reform the most important determinant of the speed and comprehensiveness of economic liberalization. De Melo, Gelb, Denizer and Tenev (2001) have analyzed the interaction of various factors, including political change and reforms, for all transition countries, such as Eastern Europe, the former Soviet Union, China, and Vietnam, and found that initial conditions such as initial macroeconomic distortions and differences in economic structure and institutions jointly determine the large differences in economic performance. Initial conditions dominate in explaining inflation, but economic liberalization is the most important factor determining differences in growth. Economic liberalization has a negative contemporaneous impact but a stronger positive effect on performance over time. Macroeconomic and structural distortions are negatively related to both policy and performance. Unfavorable initial conditions discourage policy reforms but do not diminish their effectiveness once they are implemented. The influence of initial conditions diminishes over time. Monetary overhangs are dissipated through inflation, industrial overhang is eroded as plants shut down, and market memory returns through experience.

Fourth, as noted by Rodrik (2007), first-order economic principles such as protection of property rights, market-based competition, appropriate incentives and sound monetary policy do not map into unique policy packages. Each country requires a specific set of policies. In this respect, IDA has been flexible—for instance, applying different policy advice to countries as diverse as China, India and the countries of Sub-Saharan Africa—and has learned from the experience of countries with different institutional structure, following different reform paths—which has led to the adoption of different "packages" of policy for post-conflict countries, for countries with high indebtedness and for re-engaging countries.

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