Governance, Development and Foreign Aid Policy

Michael J. Crosswell

Senior Economist
U.S. Agency for International Development (USAID)
Washington D.C. USA
mcrosswell@usaid.gov
(703-524-6915)

For presentation at the 2010 Oxford Business and Economics Conference; St. Hugh's College, Oxford University, UK. June 28-30, 2010. Views are strictly those of the author and do not reflect official USG positions.

Governance, Development and Foreign Aid Policy

ABSTRACT

The determinants of good governance and the links between good governance and development progress are important for a number of foreign aid policy and strategy issues. This paper views governance as a function of both political will and resources and capacity. We first provide some rudimentary statistical analysis that lends support to this view of governance. It also suggests that the *relative roles* of political will and resources/capacity vary depending on the dimension of governance. Expressed differently, some dimensions of governance are more resource intensive than others. We then examine the implications for a number of foreign aid policy and strategy issues and debates, with the intention of demonstrating that the framework and findings help to clarify the issues and resolve at least some of the debates.

INTRODUCTION

Much of U.S. foreign aid policy rests on the proposition that good (and/or improving) governance is the key to both development progress and the effectiveness of foreign aid. We have emphasized this in the Monterrey Declaration, in the justification for the Millennium Challenge Account (MCA), and elsewhere. While we have emphasized the causal link from good (or improving) governance to development performance and progress, we have paid less attention to – and often demonstrated some confusion about – what causes good governance; whether development progress leads to good governance; and whether and how foreign aid can contribute to improved governance.

The determinants of good governance and the links between good governance and development progress are important for a number of development policy and strategy issues – including the basic rationale and role for foreign aid; the rationale for and application of selectivity in allocating aid; criteria for graduation; the impacts of globalization on developing countries; the links between democracy and development; the role and rationale for the Millennium Challenge Account (MCA); and groupings of countries for strategic purposes, including "fragile states".

The argument in this paper is that governance is best viewed as a function of both *political will* and *resources and capacity*. "Resources and capacity" include not just financial resources but also human resources, infrastructure, technology and knowledge, institutional capacity, etc. Increases in such resources and capacity are typically part and parcel of development progress. "Political will" or "commitment" is much less tangible and less readily measured or even defined. Nonetheless, it is frequently invoked in discussions of selectivity and aid effectiveness. The key assumption here is that – unlike resources and capacity – political will does **not** depend on level of development.[a]

[a] A second key assumption is that while foreign aid can support and reinforce political will, it cannot "buy" or generate political will. This was emphasized in Assessing Aid (Dollar & Pritchett (1998)), which gave rise to a renewed focus on selectivity, including the MCA; and in many critiques of conditionality. This does not preclude measured/modest efforts to better inform the policy process and to "strengthen the hand" of reformers.

This view of the determinants of good governance provides a rationale for foreign aid as a resource to help support improvements in governance and institutional performance, and thereby promote sustainable development progress. It suggests that the quality of governance will tend to improve with development progress, other things (in particular, *political will*) equal. It also provides a rationale for selectivity. Aid to support improved governance is likely to be more effective where political will is favorable.

The following rudimentary statistical analysis lends support to this view of governance. It also suggests that the *relative roles* of political will and resources vary depending on the dimension of governance. Expressed differently, some dimensions of governance are more resource intensive than others. We first look at economic freedom scores and political freedom scores and their relationship to per capita income and other development indicators. We then examine the six dimensions of governance measured by the Kaufmann/Kraay "Governance Matters" scores.

We conclude by discussing some of the implications for various policy and strategy issues mentioned above. The annex tables contain country data.

GOVERNANCE AND DEVELOPMENT: RESULTS FOR ECONOMIC FREEDOM AND POLITICAL FREEDOM

Here we look at the links between various indicators of development progress and governance as represented by economic and political freedom scores. The correlation results presented below cover a sample of 54 "Third World" countries with 2006 per capita incomes below $4000 (roughly the eligibility threshold for MCA; and the "Sustaining Partner" threshold in the Foreign Assistance Framework introduced as part of aid reform in 2006.) The sample size is determined by availability of economic freedom scores from CATO/Fraser Institute. Formerly communist countries are **not** included. Their patterns of development have been quite distinct, and are more aptly described as "transition" from one set of political and economic institutions to another.

The variables (all for 2006 except for the last) include:[b]

- *Per capita income in Purchasing Power Parity* (PPP) terms, considered to be a superior indicator of real income and resource availability, particularly compared with
- *Per capita income in $ terms* using the Atlas Method, the more popular measure.
- *Political Freedom* as gauged by Freedom House, using the total from their component scores, with 100 as the top score.
- *Economic Freedom* scores from the CATO/Fraser Institutes, on a ten point scale.
- *Fertility,* a good overall measure of level of development insofar as it is influenced by health, education, economic opportunity, and status of women.
- *Life Expectancy*
- *Child Mortality*
- *Economic growth* in per capita income between 2001 and 2008.

[b] Data are from Freedom House (2008), Gwartney (2008), and IBRD (2008b)

The correlations are color coded based on some arbitrary boundaries and terms:

- "Very high" correlations -- .90 or above -- in black
- "High" correlations -- .70 to .89 – in green.
- "Significant" correlations -- .50 to .69 – in red
- "Modest" correlations -- .30 to .49 – in purple
- "Weak" correlations -- .10 to .29 – in blue.

Note that for a simple regression, the regression coefficient is the square of the correlation coefficient. So, a correlation coefficient of .50 yields an R-squared of .25; and a correlation coefficient of .70 yields an R-squared of .49. Thus, differences in correlation coefficients are magnified when they are squared. Note also that some of the correlation coefficients discussed below are "borderline". The descriptors should be interpreted accordingly.

Table 1: Correlations for 54 developing countries with per capita incomes below $4000 (See Annex Table 1)

	PPPCI	$ PCI	Polit. Free	Econ Free	Fertility	Life Expec.	Child Mort.	Growth 01-08
PPPCI	1.00							
$ PCI	**0.96**	1.00						
Pol Free	0.36	0.33	1.00					
Eco Free	0.49	0.47	0.51	1.00				
Fertility	-0.77	-0.70	-0.20	-0.39	1.00			
LifExpec.	0.79	0.70	0.35	0.48	-0.81	1.00		
ChldMort.	-0.78	-0.71	-0.24	-0.47	**0.91**	-0.87	1.00	
Grth01-08	0.26	0.20	0.25	0.48	-0.20	0.27	-0.14	1.00

A number of relationships are worth noting. First the indicators of level of development (the per capita income indicators and the social indicators) are all highly correlated with one another. The correlation coefficient between the two per capita income variables is very high, and the correlation coefficients among the three social indicators are high to very high. Further, per capita income – especially in purchasing power parity terms – is highly correlated with the three social indicators. This suggests a *strong (but not iron clad) tendency for economic and social well-being to increase in step with each other*. Expressed differently, progress with respect to any one of these indicators appears to be "part and parcel" of overall development progress. It also suggests that per capita income by itself, particularly in purchasing power parity terms, does a fairly good job of representing both level of development and resources and capacity as discussed in this paper.

Second, the correlations between economic freedom and per capita income; and between political freedom and per capita income are "modest". *This is consistent with the argument that good governance depends on* ***both*** *resources (human, financial, etc.) and political will.* If political will were not important, the correlation would be much higher. If resources were not important (and maintaining the assumption that political will is NOT a function of level of development) the correlation would be much lower.

Third, within the range covered by "modest", the relationship between *economic freedom* and economic and social development indicators is markedly stronger than the relationship between *political freedom* and economic and social development indicators. This suggests that *political freedom depends more on political will (relative to resources) than does economic freedom.* Expressed differently, the most important elements of political freedom (e.g. elections, basic freedoms and rights) are more readily provided "with the stroke of a pen" than are the major elements of economic freedom (e.g. property rights, effective regulation, effective provision of services) for which resources and capacity arguably matter more.

Fourth, the correlations with economic growth are all weak except for economic freedom. This is heartening insofar as it indicates that poor countries are not clearly disadvantaged in the quest for growth – they are not caught in "poverty traps." The stronger relationship between economic growth and economic freedom fits well with other results that indicate that initial levels of economic freedom **and** improvements in economic freedom over a given time period are both statistically significant in explaining per capita income growth over the same period. (Crosswell 2009) More generally, it supports the main message of USAID's Economic Growth Strategy – that policies and institutions are the critical factors affecting economic growth. (USAID 2008). At the same time, the *weak* relationship between political freedom and economic growth casts doubt on the proposition that political freedom is a critical requisite for economic growth.

Finally, political freedom and economic freedom are "significantly" correlated, but barely. They are far from highly correlated, suggesting that they are not inextricably or even strongly intertwined.

GOVERNANCE AND DEVELOPMENT: RESULTS FOR THE KAUFMANN-KRAAY GOVERNANCE INDICATORS

The Kaufmann-Kraay indicators (Kaufmann, Kraay, & Mastruzzi 2008) cover six aspects or dimensions of governance:

- Voice and Accountability
- Political Instability and Violent Conflict
- Government Effectiveness
- Regulatory Quality
- Rule of Law
- Control of Corruption

Here we look at a larger sample of seventy-one developing countries with per capita incomes under $4000 – those covered by Kaufmann-Kraay scores and for which per capita income figures are available. The sample of countries is larger because the Kaufmann-Kraay scores cover more countries. They pertain to 2007, so we use 2007 figures for per capita income. (Note that the two per capita income columns are in reverse order from the previous table). Since per capita income is highly correlated with social indicators, we drop those and use per capita income as a summary indicator of level of development and of resources/capacity. We continue to focus on countries with per capita incomes below $4000; and we continue to exclude formerly Communist countries.

We use the same color coding and terms to describe the correlations.

Table 2: Correlations for 71 developing countries with 2007 per capita income below $4000 (See Annex Table 2)

	PCI Atlas	PCI PPP	Voice &Accn	Violence & Instab	Govern. Effect.	Regulat. Quality	Rule of Law	Control Corrup.
PCI Atlas	1.00							
PCI PPP	0.96	1.00						
Voice &Account	0.31	0.22	1.00					
Violence & Instability	0.22	0.14	0.46	1.00				
Government Effect.	0.53	0.52	0.54	0.47	1.00			
Regulatory Quality	0.52	0.51	0.54	0.41	0.84	1.00		
Rule of Law	0.37	0.36	0.45	0.54	0.87	0.73	1.00	
Control of Corruption	0.44	0.38	0.46	0.53	0.79	0.62	0.85	1.00

These correlation coefficients provide further support to the proposition that governance depends on both resources and political will, but with some variation (across dimensions of governance) in the relative roles these two factors play. As with the previous results, per capita income is correlated to varying degrees with different dimensions of governance, but is not *highly* correlated with any. Within the framework described at the beginning of this note, this suggests that political will always matters.

Further, leaving aside "Violence and Instability", the weakest correlation is with "Voice and Accountability", particularly where per capita income in purchasing power parity terms is concerned. This again suggests that political freedom is relatively less resource intensive, and relatively more dependent on political will. (Voice and Accountability is *very highly* correlated with the Freedom House scores – a correlation coefficient of .95).

The remaining four dimensions of governance are more strongly correlated with per capita income, but in no case is the correlation coefficient much above .5. These four dimensions of governance also tend to be *highly* correlated with one another. They are less closely related to voice and accountability.

IMPLICATIONS FOR VARIOUS FOREIGN AID POLICY ISSUES

It is widely accepted that the key to development progress is good (or improving) governance.[c] However, the links between good governance and development progress are not unidirectional. Development progress – including rising incomes, improved human resources, reduced poverty, greater access to knowledge and improved technology, more and better infrastructure, greater "connectedness" and integration, stronger institutions, etc. – increases the *feasibility* of good governance by increasing relevant resources and capacity. Political will then becomes critically important in determining whether resources and capacity are actually put to good use.[d]

This simple "model" of governance sheds light on a number of policy debates and issues:

The Rationale and Purpose for Foreign Aid:

Some critics of foreign aid – especially on the conservative side -- have agreed that good

[c] We skip over an important point for the time being. Poor countries are limited to a significant (and varying) degree in the levels of governance they can achieve because they lack important kinds of resources. However, it is clear from the record on economic growth that *improvements* in governance, even from a low base, contribute to faster growth. More generally, poor countries are handicapped -- *but not trapped* -- by lack of resources in their efforts to make progress. For evidence see Crosswell (2009).

[d] There are several analogies from economics. One could think of a production function for governance, with various kinds of resources as the "factors of production", and where "political will" plays the role of an efficiency parameter. Alternatively, one could view governance in terms of a production function with two "factors of production" – political will and resources/capacity. Increases in either factor would raise the marginal product of the other. Thirdly, one could draw analogies with growth theory, where political will accounts for the "unexplained residual" once increases in resources have been taken into account.

governance in the form of economic and political freedom is critical for development progress. But, they tend to view economic and political freedom as *simply and purely matters of political will*. Therefore, relatively low scores for political and economic freedom in poorer developing countries mean they are simply not trying. Accordingly, foreign aid to such countries is likely to be wasted, or even counter-productive. Thus, “countries that deserve foreign aid don’t need it, and countries that need foreign aid don’t deserve it.” This line of argument – combined with (false) allegations that foreign aid recipients have made little or no progress -- has been popular at the Heritage Foundation, the CATO Institute, and the American Enterprise Institute among others.[e]

A more accurate statement is that even with the best of intentions, political and especially economic freedom require resources of various types, all of which are quite scarce in poor countries. With adequate political will, foreign aid can help improve governance and strengthen institutions in poor countries by augmenting and building up some of these resources (e.g. training, equipment, technical assistance, and financial assistance.)

Others – particularly on the liberal side -- see foreign aid as mainly a matter of directly helping needy people. Recipient governments in poor countries tend to be inefficient, ineffective, and corrupt – governance is demonstrably weak. So, it is fitting and proper to bypass such governments and target aid directly at needy people, especially through non-governmental organizations.

This approach offers immediate help to people; visible and tangible results; and might make some contribution to human resource development over the medium to long term if provided on a sustained basis. However, it does little to influence and support the main drivers of development progress – improvements in policies and institutions – and may even undermine them as skilled people leave government to work for non-governmental organizations engaged in service delivery.

Caught between these two points of view, efforts to mobilize U.S. foreign aid for programs aimed at policy reform, institutional strengthening, and improved governance have faced a steep uphill battle – in both the Administration (especially in “results-oriented” OMB) and in Congress; and regardless of the party in power in either branch. Even where there is a clear emphasis on focusing aid on countries with strong commitment (e.g. the MCA – see below), there is strong reluctance to use foreign aid for the admittedly complex and metric-resistant task of improving policies, institutions and governance.

Selectivity, the MCA and the Foreign Assistance Framework

Selectivity recognizes the importance of policies, institutions, and governance to both aid effectiveness and development progress; and the importance of political will and commitment to improvements in policies, institutions, and governance. Selectivity calls for gauging commitment

[e] For documentation and refutation of these claims, see Crosswell (1998, 2008)

to good governance and prioritizing countries where commitment is found to be strong. It is in these countries that aid effectiveness and development progress are likely to be greatest.

In gauging commitment to good governance, it is important to try to "isolate" political will and to control for resource availability so as not to disadvantage poor countries in the prioritization process. One approach is to focus on policies and measures that even poor countries can readily succeed at (e.g. controlling inflation). A second is to compare countries with their peers in terms of resource availability. USAID, the World Bank, and MCA have all recognized this in their approaches to gauging commitment and exercising selectivity.[f]

However, selectivity was arguably misconceived in both the MCA and the "Foreign Assistance Framework" that provided the conceptual framework for aid reform.[g] In both cases, good policy performance (as revealed by the MCA "hurdles" methodology – a reasonably good approach to gauging policy performance and commitment) was seen as virtually a "distinct stage of development".

For instance, the Foreign Assistance Framework singled out "transforming countries" – those with satisfactory scores on MCA policy indicators – as a distinct group. For this group – and for MCA recipients more generally – the governance challenge was seen as largely met (absent backsliding), so that only resource transfers – in the form of large, lumpy projects under MCA compacts – were required for rapid growth. It was frequently argued that the role for AID (and/or for MCA threshold programs) was to get countries to this "stage". Then aid in the form of MCA compacts could "take over". Such compacts have typically addressed rural development and/or infrastructure; and in no case primarily focus on supporting further improvements in governance. The slow rates of disbursement for MCA resources would have come as no surprise, had it been recognized that in poor countries, relatively good policies can and do coincide with weak institutions and limited capacity.

All of this contrasts sharply with an approach that sees both the need and the opportunity for ongoing improvements in governance to sustain and accelerate development progress, and for foreign aid to support such improvements. These efforts would be mainly but not exclusively focused on countries with at least adequate commitment – as demonstrated by policy performance, and with allowance for income and resources.

Aside from illuminating the misconceived distinction between "transforming" and "developing" countries, the view of governance presented earlier sheds light on two additional issues related to country groupings for strategic purposes: identifying "fragile states"; and the weak correspondence between country groupings based on standard development criteria and groupings based on democracy criteria.

---

[f] Though MCA could go further by sub-dividing the "low-income" group of eligible countries, which span a range from $110 to $1785. The World Bank's Country Policy and Institutional Assessment (CPIA) scores remain modestly correlated with per capita income -- .38 and .45 for Atlas and PPP respectively. These indicators of policy performance are publicly available on the web sites of Millennium Challenge Corporation and the World Bank.

[g] For more detail on the discussion that follows see Crosswell (2007) and Arkedis & Crosswell (2008).

Identifying Fragile States for Programmatic Purposes

Fragile states (for foreign aid purposes) are those where political instability and violence and weak governance are such that standard, medium-term development assistance programs are neither feasible nor appropriate. Instead, different kinds of aid programs are called for that allow for and address the basic drivers of fragility.[h]

Identifying fragile states is not simply a matter of identifying countries where serious conflicts exist. Many countries, including Ireland and Spain, have faced ethnic divisions and conflicts without becoming fragile. More generally, recall that violence/instability as gauged by Kaufmann/Kraay is only weakly correlated with per capita income. An important consideration is the *will* and the *capacity* of a conflict-ridden country to deal with and manage the divisions that give rise to the conflict; and to maintain and improve policies that make development progress feasible – particularly insofar as broadly based development progress can ease the tensions and pressures that generate conflict.

Most of the efforts to identify weak or fragile states use a combination of indicators, including some that pertain to conflict and violence; some that pertain to low levels of development (e.g. high infant mortality and low per capita income); and some that pertain to weak governance. Depending on the relative weights for these three factors, countries such as India, Sri Lanka, and Colombia – relatively good policy performers where development progress and effective development programs are demonstrably feasible – have been seen as fragile for programmatic purposes.

At the other extreme (in terms of number and variety of indicators), the IBRD considers "fragile states" essentially as those with low scores in the Country Policy and Institutional Assessments (CPIA), without regard to conflict or instability. In this case fragile states are synonymous with weak partners or weak policy performers.[i]

An approach used successfully in USAID during 2004-06 used two indicators for an initial screen: The Kaufmann/Kraay violence/instability indicator; and the CPIA as a measure of commitment and policy effort. The initial/draft list was then vetted with regional bureaus with an eye to their views on the feasibility and appropriateness of medium-term development programs, as opposed to programs with a shorter time horizon aimed at fragility. This approach eliminated many of the anomalies presented by more complex, "kitchen sink" approaches to state weakness and fragility, while improving on the overly simple IBRD approach that focuses only on policy performance but not on instability.

---

[h] The discussion in this section is based on USAID/PPC (2006). See also USAID's Fragile States Strategy (USAID, 2005).

[i] See IBRD (2008a), "Global Monitoring Report 2008", Annex; the footnote for MDG 1 Figure 3. "Fragile states are low-income countries or territories with no CPIA score or a CPIA score of 3.2 or less."

Democracy, Development, and Selectivity

Once fragile states have been accurately identified for programmatic purposes, it is important to group other developing countries according to need and commitment for purposes of strategic prioritization and programming from a development perspective.[j] Best development practice is to focus resources on countries that are *both* needy (i.e. poor and relatively less developed) *and* committed (as evidenced by policy performance, with "controls" for resource availability).

The previous discussion pointed out that per capita income along with suitable social indicators – as in the UN Human Development Index – provides a reasonable ranking of countries with respect to *need*. And, World Bank and MCA indicators of policy performance do a good job of gauging *commitment*, as they do reasonably well at controlling for resource availability. Both approaches incorporate considerations of political freedom.

However, there are at least two challenges for bringing democracy into this prioritization framework. *First*, the correlations presented above (for Freedom House and for the Kaufmann/Kraay Voice and Accountability scores) suggest that democracy is NOT like economic and social indicators, which tend to steadily improve together as countries make development progress. Instead, progress on democracy bears little relation to level of development – the correlations with economic and social development indicators are all weak or barely "modest". *Therefore, democracy does not track well with other "need" indicators that show country poverty and level of development.* There may be a great "need" for progress in democracy in one or another country. But, a low democracy score does not indicate whether a country is likely to be poor and less developed or not. In sum, progress with respect to democracy is apparently not "part and parcel" of overall development progress.[k]

Second, the correlations instead suggest that – unlike other dimensions of governance – democracy (as represented by Freedom House and by Voice and Accountability) is mainly a matter of political will and not of resource availability. So, where "need" for progress in terms of democracy is great, "commitment" is likely to be low. In the case of democracy they are two sides of the same coin.

However, the aid literature suggests that adequate recipient commitment is essential to aid effectiveness -- a principle enshrined in the MCA. So, if the neediest countries where democracy is concerned are simultaneously the least committed, this creates a major dilemma for selectivity and aid effectiveness.

---

[j] Population size should also be taken into account.

[k] At least for countries with per capita incomes below $4000 -- the countries of interest from the standpoint of developmental foreign aid. Many have argued that at higher levels of income and development, democracy becomes more feasible and likely. But it is certainly feasible in poor countries. Indeed, a look at current and historical Freedom House scores reveals numerous examples of poor, even least-developed countries with high scores (i.e. "Free"), including Benin, Mali, Gambia, Ghana, Namibia, Cape Verde, Bangladesh, Lesotho, Sao Tome and Principe, and Senegal. For a much broader and deeper analysis of the links between income and democracy, see Acemoglu et al (2008). They find no reliable links – neither correlation nor causality – between income and democracy.

A reasonable solution is to treat democracy as its own important, distinct concern – with its own distinct budget and strategic guiding principles for resource allocation across and within countries. "Need" and "Commitment" should certainly come into play – but there would be no expectation that priority countries for democracy would be the same as priority countries for more conventional development efforts. Obviously, this would still allow for considering democracy (and basic freedoms and human rights) in prioritizing recipients of development aid, or at least in determining eligible countries.[l]

Graduation from Developmental Foreign Aid

A closely related policy concern is graduation. A general principle is that foreign aid should aim to help countries move towards "graduation" rather than promoting perpetual dependence on foreign aid. The typical approach is to identify the key variables and indicator values that signal "success" and use them as graduation thresholds. *Need* is then commonly measured by the distance between current values and graduation thresholds – the greater the distance, the needier the country. As that distance diminishes with development progress, countries move towards graduation.[m]

In a development context there are at least three approaches to this:

The *first* approach looks solely at per capita income. The rationale is twofold:

- As evidenced in the correlations, per capita income is a pretty good indicator of level of development insofar as it is highly correlated with various economic and social development indicators that also distinguish poor from advanced developing countries.
- Further, per capita income – as a general measure of financial resource availability -- indicates the degree of need for foreign assistance as a *financial* resource. At a certain per capita income level, countries are judged to have the financial resources to make further progress on their own. In this sense, per capita income is as much an eligibility criterion as a graduation criterion.

Both the World Bank and the Millennium Challenge Corporation use per capita income as an eligibility/graduation criterion. The afore-mentioned Foreign Assistance Framework also pointed in that direction, though the implications were never fully fleshed out.

---

[l] Much more could be said about the implications of the political will/resources and capacity framework for looking at the challenge of democracy, and programs aimed at democracy. For instance, a recent paper -- "Democracy Assistance: Political vs. Developmental?" – identifies two distinct approaches to fostering democracy. (Carothers 2009) The "political" approach appears to target political will, while the "developmental" approach focuses mainly on building capacity. Carothers questions the effectiveness of the latter approach. To the extent that democracy depends mainly on political will, that is both a reasonable and answerable question.

[m] Graduation from developmental foreign aid does not preclude continued aid for other important concerns, e.g. global issues and other special foreign policy concerns.

The *second* approach to graduation looks at per capita income and other indicators, particularly for health and education – indicators that tend to systematically improve with development progress. This approach is illustrated by the Human Development Index; and by an index of need used for budgeting purposes in USAID and subsequently in the Office of the Director of Foreign Assistance during 2004-06.

This second approach allows for continued developmental aid to countries that have a suitably high per capita income, but lagging social indicators. It can be justified by arguing that foreign aid is not just about needy countries, but also needy people – even those in countries that are not so poor.

The counter argument would be that our aid may then substitute for self-help efforts by recipients, and provide incentives for them not to mobilize their own resources. An important consideration would be why social indicators in a particular country might lag economic indicators, relative to a "typical" relationship between per capita income and social indicators.[n]

A *third* approach to graduation thresholds includes not just the standard economic and social indicators of level of development, but also indicators of governance – including democracy. As we have seen, these indicators depend on both political will and resources. A country with high economic and social indicators (signaling high resource availability, both financial and human) and low governance scores would seem to be deficient in political will – especially for those areas of governance, like democracy, where resources do not seem to be so important. Prolonged aid would therefore be inappropriate (as a reward for weak commitment); and also ineffective (insofar as aid effectiveness depends on political will and commitment).[o]

The general point is that an appreciation of the close links between economic and social development indicators -- along with recognition that governance depends on political will and also on resources that increase with development progress -- provide insights on how best to approach graduation.

Globalization, Development, and Foreign Aid

There has been considerable debate whether globalization is good or bad for developing countries. An important but often neglected consideration is the quality of governance. Globalization can be thought of as the phenomenon of rapid and ongoing declines in the costs and obstacles associated with crossing national borders. Thanks to advances in transportation,

---

[n] There is also the possibility that countries with lower per capita incomes but good social indicators (Sri Lanka was the classic case for a long time) would face graduation earlier than otherwise, which could be seen as penalizing good performance.

[o] Similar comments apply to "income distribution" as a graduation criterion. First, income distribution does NOT typically improve (or deteriorate) with development progress (unlike the incidence of absolute poverty, which tends to decline steadily). Nor is there much evidence that aid is a useful instrument for altering income distribution, despite years of efforts at raising the income share of the poor. If anything, skewed income distribution would raise issues of political will rather than development shortfalls.

communications, and information technology, all sorts of “things” move across borders more readily.

This includes many “good things” – trade in merchandise and even services, capital flows and remittances, information, technology, knowledge, and “helpful” people. This generates both major opportunities and major rewards for development progress.

However, it also includes many “bad things” – diseases, pollution and climate change, international economic instability, weapons, narcotics, trafficking in persons, money laundering, other forms of international criminal activity, and terrorism. These generate major threats to development progress. Further, they are of concern to the U.S. in their own right, apart from their implications for development progress.

Accordingly, with globalization and increased interdependence among countries, U.S. interests in developing countries have expanded and deepened. And, the agenda for foreign aid has become much more complex and multifaceted, extending well beyond “development” as commonly understood. Developing countries represent the fastest growing markets for U.S. trade and investment, and are increasingly central to growth in U.S. output and employment. Humanitarian concerns in developing countries are larger and more visible than ever. The threats to the U.S. from the “bads” of globalization – infectious diseases, narcotics, uncontrolled migration, pollution and climate change, etc. – command increasing attention. Consequently, foreign aid addressing these concerns has expanded rapidly.

This has major and often overlooked implications for foreign aid policy and evaluation. On the policy side, best practice guidelines for developmental foreign aid may not be applicable to aid for other foreign policy concerns. An obvious and long-standing example is humanitarian aid, provided without regard to recipient commitment to good policies, and without a central concern for strengthening institutions and governance or achieving sustainable results over the medium term. More recent examples include aid directed at an expanding array of global issues and other foreign policy concerns (besides development). The principles for strategic management for such issues and concerns may be quite different than for developmental foreign aid. (USAID 2004, 2006)

What determines the extent to which developing countries benefit from globalization? Certainly a major (if not THE major) factor is the quality of governance, as determined by the *will* and *capacity* of a government to take advantage of the opportunities afforded by globalization, and to avoid or contain the threats.

This appears to put developing countries – particularly poor developing countries – at a considerable disadvantage and risk, since capacity tends to be weak, and resources of various kinds tend to be scarce in such countries. However, this does not mean that low-income developing countries cannot benefit from globalization.

First, as we have seen, resources and capacity are not the whole story. While governance indicators are correlated with level of development as represented by per capita income, the correlations are far from “high” and instead tend to be “modest” or barely “significant”. Political will appears to play an important role in most dimensions of governance, and is arguably *not* dependent on level of development.

Further, growth performance in the developing world improved dramatically between 1995 and 2008, especially among low-income countries and especially in Africa. This coincided with rapid and accelerating globalization. Statistical analysis indicates that economic governance – as represented by levels and improvements in economic freedom – explains a major portion of the variation in economic growth rates among countries. Poor countries cannot quickly achieve high *levels* of economic freedom owing to resource limitations. However, with political will supported by foreign aid and other resources, they CAN achieve steady improvements. And, those improvements are associated with faster growth. (Crosswell 2009)

More generally, globalization offers great rewards to good and/or improving governance – even in poor countries. On the other hand, the penalties for persistently weak and/or declining governance can be severe.

CONCLUSION

This paper was stimulated by discussion and debate of a range of foreign aid policy issues, many of which remain open and unsettled. Many of the disagreements seem to revolve around differing or unclear views of governance, and the links between governance and development. In an effort to move these discussions and debates forward, this paper posits and tests a simple framework for looking at governance that emphasizes two factors – political will and resources/capacity. Political will is assumed to be independent of the level of development, while resources/capacity is treated as virtually synonymous with level of development, as represented for example in the Human Development Index. This framework fits pretty well with the data – with economic and social indicators of development and with various indicators of governance. Further, the correlation results suggest that some dimensions of governance – particularly political freedom or “voice and accountability -- are significantly *less* resource-intensive than others and depend largely on political will. These findings arguably clarify and help resolve a number of persistent foreign aid policy issues that have been subject to ongoing debate. Short of that, they hopefully suggest avenues for further testing and analysis.

Acemoglu, D., Johnson, S., Robinson, J. & Yared, P. (2008). Income and democracy, *American Economic Review*, Volume 86, Number 3, June 2008

Arkedis, J. & Crosswell, M. (2008). Improving the foreign assistance framework: use and configuration of the country categories. USAID/State Discussion Paper, June 2008

Carothers, T (2009). Democracy assistance: political vs. developmental? *Journal of Democracy*, Volume 20, Number 1, January 2009.

Crosswell, M. (1998). The development record and the effectiveness of foreign aid. USAID Discussion Paper, June 1998, reprinted in *PRAXIS*, The Fletcher Journal of Development Studies, Volume XV, 1999. *http://fletcher.tufts.edu/praxos/archives/xv/Crosswell.pdf*

Crosswell, M. (2007) Misconceptions surrounding the Millennium Challenge Account. USAID Economic Growth Workshop, Washington, D.C. October 2007. *www.egworkshop2007.net/proceedings.html*, Session 25.

Crosswell, M. (2008). The development record and the effectiveness of foreign aid – update. 2008 Oxford Business and Economics Conference; St. Hugh's College, Oxford University, UK. June 22-24, 2008. www.facultyforum.com/gcbe/

Crosswell, M. (2009). The far-from-elusive quest for growth: economic performance in developing countries, 1996-2008. 2009 Oxford Business and Economics Conference; St. Hugh's College, Oxford University, UK. June 24-26, 2009. www.facultyforum.com/gcbe/

Dollar, D. & Pritchett, L. (1998). *Assessing aid: what works, what doesn't, and why*. Washington D.C., Oxford University Press/World Bank.

Freedom House (2008). *Freedom in the world*. Available at *www.freedomhouse.org*

Gwartney, J. & Lawson, R. (2008) *Economic freedom of the world: 2008 annual report.* CATO Institute, Washington D.C. Available at *www.freetheworld.com/release.html*

IBRD (2008a). *Global monitoring report 2008.* Washington D.C. The World Bank

IBRD (2008b). *World development indicators 2008.* Washington D.C. The World Bank

Kaufmann, D., Kraay, A., & Mastruzzi, M. (2008) Governance matters vii: aggregate and individual governance indicators 1996-2007. The World Bank, Washington D.C., June 2008. http://info.worldbank.org/governance/wgi/pdf/GovernanceMattersVII.pdf

USAID (2004). White Paper: U.S. foreign aid -- meeting the challenges of the twenty-first century. U.S. Agency for International Development, Washington, D.C. January 2004. www.usaid.gov/policy/

USAID (2005). Fragile states strategy, U.S. Agency for International Development, Washington D.C., January 2005. www.usaid.gov/policy/

USAID (2006). Policy framework for bilateral foreign aid, U.S. Agency for International Development, Washington D.C., January 2006. www.usaid.gov/policy/

USAID/PPC (2006). Approach/methodology – country array 2006, unpublished paper, June 2006 available from mcrosswell@usaid.gov

Annex Table 1 -- Countries (54) and Indicators for Political and Economic Freedom:

Country	PCIPPP 2006	PCI $ 2006	PF 2006	EF 2006	Fertility 2006	LE 2006	CM 2006	PCI Growth 01-08
Burundi	320	100	4.9	5.1	6.8	49.0	181.0	-0.5
Congo DROC	270	120	2.0	5.1	6.3	46.1	205.0	3.3
Malawi	690	160	5.7	5.4	5.7	47.6	120.2	2.5
Guinea-Bissau	460	180	5.9	5.0	7.1	46.2	200.1	-2.3
Sierra Leone	610	220	6.0	5.7	6.5	42.2	270.1	6.0
Rwanda	730	230	3.2	4.2	5.9	45.6	160.3	3.5
Niger	630	240	6.2	4.1	7.0	56.4	253.2	1.0
Nepal	1,010	270	2.8	5.0	3.1	63.2	59.4	1.3
Uganda	880	280	4.5	6.6	6.7	50.7	134.2	4.7
Madagascar©	870	290	6.0	5.8	4.9	59.0	115.4	0.6
Tanzania*	980	340	5.8	6.4	5.3	51.9	118.2	4.5
Zimbabwe	*770*	340	1.5	2.4	3.8	42.7	105.0	*-6.3*
Cent Afr. Rep	690	350	4.4	4.9	4.7	44.4	174.8	-0.7
Togo	770	350	2.5	4.7	4.9	58.2	108.0	-0.3
Mali	1,000	380	7.4	6.0	6.6	53.8	216.8	1.6
Chad	1,170	400	2.6	5.0	6.3	50.6	209.0	5.2
Ghana	1,240	450	8.4	7.0	3.9	59.7	119.9	3.5
Haiti	1,070	450	2.1	5.8	3.6	60.3	80.2	-0.7
Bangladesh	1,230	470	5.3	5.8	2.9	63.7	69.2	4.2
Zambia	1,140	490	5.6	7.1	5.3	41.7	182.0	3.4
Benin	1,250	510	7.8	6.0	5.5	56.2	148.0	0.7
Kenya	1,470	530	6.6	6.7	5.0	53.4	120.6	1.6
Nigeria	1,410	560	4.9	5.9	5.4	46.8	191.4	6.7
Pap New Guin.	2,410	660	6.4	6.3	3.9	57.3	73.3	0.9
Pakistan	2,410	690	3.5	5.9	3.9	65.2	97.2	3.6
Senegal	1,560	710	7.6	5.5	5.3	62.8	116.2	1.6
India	2,460	720	7.6	6.6	2.5	64.5	76.4	6.4
Cote d'Ivoire	1,580	840	2.1	6.0	4.6	48.1	127.2	-0.9
Nicaragua	2,720	910	6.3	6.7	2.8	72.5	35.8	2.0
Congo, Rep	*2,420*	950	3.7	4.7	4.6	54.8	126.5	1.9
Bolivia	3,810	1,010	7.1	6.3	3.6	65.2	61.2	2.2
Cameroon	2,060	1,010	2.7	5.8	4.4	50.3	148.6	1.3
Guyana	3,410	1,010	7.0	5.6	2.4	66.3	61.6	2.1
Sri Lanka	3,730	1,160	5.9	6.0	1.9	75.0	12.9	4.9
Honduras	3,420	1,190	6.6	7.0	3.4	69.9	27.0	3.3
Egypt	4,940	1,250	3.0	6.8	2.9	71.0	35.3	3.3
Indonesia	3,310	1,280	6.5	6.2	2.2	68.2	33.6	4.1
Paraguay	4,040	1,280	6.3	6.2	3.2	71.7	22.2	1.9
Philippines	3,430	1,300	7.2	6.5	3.3	71.4	31.6	3.3
Morocco	3,860	1,730	4.3	6.2	2.4	70.7	37.2	3.7
Colombia	6,130	2,290	6.0	5.6	2.3	72.6	20.7	3.6

Dominican Rep	5,550	2,370	7.8	6.1	2.8	72.0	29.2	4.0
Guatemala	5,120	2,400	5.5	7.2	4.2	69.9	41.0	1.5
El Salvador	5,610	2,450	7.5	7.4	2.7	71.5	25.4	1.6
Jordan	4,820	2,500	4.2	7.1	3.2	72.2	25.2	3.5
Peru	6,490	2,610	7.4	7.0	2.6	71.1	25.2	5.4
Ecuador	6,810	2,630	6.8	5.6	2.6	74.8	23.6	3.3
Thailand	7,440	2,750	6.7	6.8	1.8	70.2	7.8	4.7
Tunisia	6,490	2,890	2.4	6.4	2.0	73.6	22.6	3.9
Namibia	4,770	2,990	7.7	6.7	3.3	52.5	60.6	3.3
Algeria	5,940	3,030	3.6	5.6	2.4	72.0	38.0	3.2
Jamaica	7,050	3,400	7.4	7.3	2.3	71.1	31.2	1.0
Brazil	8,700	3,460	7.7	6.2	2.3	72.1	20.0	2.5
Belize	7,080	3,740	8.8	6.6	2.9	71.9	16.3	1.7

Annex Table 2 -- Countries (71) and 2007 Indicators for Per Capita Income and Kaufmann-Kraay Scores

Country	PCI Atlas	PCI PPP	Voice/ Accoun	Instab.	Gov. Effec.	Reg. Qual.	Rule of Law	Contrl. Corrupt.	FH2007
Burundi	110	330	-0.80	-1.42	-1.34	-1.21	-1.16	-1.06	4.50
Congo, DRC	140	290	-1.46	-2.26	-1.68	-1.35	-1.67	-1.27	2.60
Liberia	150	290	-0.35	-1.15	-1.18	-1.24	-1.06	-0.41	7.30
Guinea-Bissau	200	470	-0.51	-0.41	-1.21	-1.10	-1.36	-1.11	5.50
Ethiopia	220	780	-1.19	-1.72	-0.45	-0.90	-0.54	-0.70	3.40
Eritrea	230	520	-2.15	-1.04	-1.30	-1.95	-1.10	-0.60	1.30
Malawi	250	750	-0.26	-0.01	-0.59	-0.51	-0.39	-0.74	5.80
Sierra Leone	260	660	-0.33	-0.30	-1.08	-1.01	-1.13	-1.02	6.00
Niger	280	630	-0.38	-0.55	-0.85	-0.56	-0.89	-0.89	6.40
Mozambique	320	690	-0.06	0.37	-0.41	-0.49	-0.68	-0.59	5.80
Rwanda	320	860	-1.24	-0.19	-0.37	-0.63	-0.65	-0.09	3.30
Madagascar	320	920	-0.04	-0.06	-0.30	-0.20	-0.35	-0.16	5.90
Gambia, The	320	1140	-0.96	-0.14	-0.71	-0.39	-0.21	-0.78	4.80
Uganda	340	920	-0.47	-1.15	-0.40	-0.20	-0.54	-0.76	4.60
Nepal	340	1040	-0.89	-2.13	-0.81	-0.65	-0.64	-0.66	4.50
Togo	360	800	-1.16	-0.52	-1.48	-0.98	-0.94	-0.98	2.90
Cent Afr. Rep	380	740	-0.93	-1.78	-1.38	-1.24	-1.52	-0.90	4.30
Guinea	400	1120	-1.23	-2.02	-1.47	-1.14	-1.47	-1.33	3.20
Tanzania	400	1200	-0.15	-0.07	-0.42	-0.37	-0.45	-0.45	5.80
Burkina Faso	430	1120	-0.31	0.09	-0.84	-0.34	-0.48	-0.40	5.30
Bangladesh	470	1340	-0.63	-1.44	-0.81	-0.86	-0.81	-1.05	5.30
Mali	500	1040	0.26	-0.13	-0.55	-0.33	-0.37	-0.43	7.40
Chad	540	1280	-1.43	-1.96	-1.45	-1.16	-1.40	-1.22	2.20
Cambodia	540	1690	-0.87	-0.43	-0.82	-0.51	-1.06	-1.08	3.50
Haiti	560	1150	-0.77	-1.34	-1.33	-0.86	-1.42	-1.28	4.20
Benin	570	1310	0.32	0.38	-0.57	-0.44	-0.56	-0.49	8.20
Lao PDR	580	1940	-1.66	0.00	-0.81	-1.08	-0.96	-1.00	4.60
Ghana	590	1330	0.50	0.22	-0.04	0.00	-0.08	-0.17	8.40
Kenya	680	1540	-0.06	-1.10	-0.59	-0.21	-0.98	-0.94	6.40
Vietnam	790	2550	-1.61	0.31	-0.41	-0.43	-0.53	-0.69	2.10
Zambia	800	1220	-0.26	0.24	-0.59	-0.48	-0.64	-0.60	5.90
Senegal	820	1640	-0.02	-0.18	-0.34	-0.35	-0.39	-0.51	7.60
Mauritania	840	2010	-0.75	-0.33	-0.68	-0.36	-0.60	-0.50	4.60
Pap New Guinea	850	1870	0.12	-0.76	-0.74	-0.51	-0.85	-1.05	6.20
Yemen, Rep.	870	2200	-1.06	-1.48	-1.02	-0.71	-0.94	-0.62	3.30
Pakistan	870	2570	-1.05	-2.44	-0.62	-0.56	-0.93	-0.83	3.50
Cote d'Ivoire	910	1590	-1.26	-2.12	-1.37	-0.98	-1.54	-1.09	2.10
Nigeria	930	1770	-0.54	-2.07	-0.93	-0.89	-1.20	-1.01	5.10
India	950	2740	0.38	-1.01	0.03	-0.22	0.10	-0.39	7.60
Sudan	960	1880	-1.73	-2.30	-1.18	-1.25	-1.46	-1.25	1.40
Nicaragua	980	2520	-0.10	-0.26	-0.91	-0.40	-0.84	-0.78	6.70
Lesotho	1000	1890	0.12	0.04	-0.42	-0.69	-0.35	-0.19	5.10
Cameroon	1050	2120	-0.94	-0.39	-0.87	-0.71	-1.09	-0.93	2.70

Djibouti	1090	2260	-1.06	-0.05	-0.98	-0.80	-0.51	-0.48	3.50
Bolivia	1260	4140	0.02	-0.99	-0.83	-1.18	-0.96	-0.49	7.10
Guyana	1300	2880	0.07	-0.32	-0.09	-0.46	-0.57	-0.64	7.30
Timor-Leste	1510	3080	-0.12	-1.09	-0.91	-1.59	-1.28	-0.92	5.90
Congo, Rep.	1540	2750	-1.11	-0.83	-1.34	-1.20	-1.26	-1.04	3.50
Sri Lanka	1540	4210	-0.39	-1.96	-0.29	-0.11	0.06	-0.13	5.40
Egypt	1580	5400	-1.24	-0.77	-0.44	-0.31	-0.13	-0.58	2.70
Honduras	1600	3620	-0.23	-0.39	-0.57	-0.22	-0.86	-0.69	6.20
Philippines	1620	3730	-0.17	-1.38	-0.01	-0.13	-0.59	-0.79	6.90
Indonesia	1650	3580	-0.17	-1.13	-0.41	-0.30	-0.71	-0.72	6.50
Paraguay	1670	4380	-0.37	-0.48	-0.85	-0.57	-0.97	-0.96	6.30
Morocco	2250	3990	-0.62	-0.52	-0.07	-0.11	-0.15	-0.24	4.50
Cape Verde	2430	2940	0.89	1.01	0.36	-0.20	0.62	0.76	9.00
Guatemala	2440	4520	-0.30	-0.76	-0.59	-0.15	-1.11	-0.75	5.70
Angola	2560	4400	-1.11	-0.46	-1.16	-1.00	-1.35	-1.12	2.90
Swaziland	2580	4930	-1.10	0.10	-0.71	-0.66	-0.76	-0.47	2.20
Jordan	2850	5160	-0.64	-0.29	0.27	0.35	0.51	0.32	4.20
El Salvador	2850	5640	0.07	0.02	-0.23	0.20	-0.68	-0.13	7.40
Ecuador	3080	7040	-0.23	-0.91	-1.04	-1.09	-1.04	-0.87	6.90
Tunisia	3200	7130	-1.22	0.10	0.46	0.15	0.32	0.08	2.40
Colombia	3250	6640	-0.28	-1.65	0.03	0.21	-0.57	-0.28	6.20
Namibia	3360	5120	0.58	0.90	0.17	0.02	0.12	0.19	7.70
Thailand	3400	7880	-0.61	-1.07	0.16	0.11	-0.06	-0.44	3.60
Peru	3450	7240	0.00	-0.83	-0.44	0.20	-0.71	-0.38	7.30
Dominican Rep	3550	6340	0.18	0.12	-0.46	-0.15	-0.55	-0.65	8.00
Algeria	3620	7640	-1.01	-1.18	-0.52	-0.66	-0.72	-0.47	3.60
Jamaica	3710	6210	0.61	0.00	0.12	0.31	-0.63	-0.49	7.40
Belize	3800	6200	0.69	0.24	-0.21	-0.28	0.02	-0.27	8.70