AID EFFECTIVENESS IN BANGLADESH

IS THE GLASS HALF FULL OR HALF EMPTY?

By

M.G. Quibria*

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*M.G. Quibria is Professor, Department of Economics, Morgan State University, Baltimore, MD 21239; and Distinguished Fellow, Policy Research Institute of Bangladesh, Dhaka, Bangladesh.
The literature on aid effectiveness is rife with controversies. There is a voluminous empirical literature based on cross-country regressions, which has produced more confusions than robust conclusions. In addition, this literature has little or nothing to contribute when it comes to individual countries. Recent years have seen the emergence of a burgeoning empirical literature based on the method of randomization. The method has been criticized for its narrow focus. It cannot tell us “what works’ in development, to design policy, or to advance scientific knowledge about development processes.” It has also been opined that it cannot be the basis for a cumulative research program that might progressively lead to a better understanding of development”. Moreover, it provides little guidance on aid effectiveness at the macro level. However, in the real world, people need to draw conclusions about aid effectiveness and make policies.

Given the manifest failures of the so-called rigorous empirical methods to yield useful insights, the present study takes a more qualitative approach to aid effectiveness. Taking Bangladesh as a case, it undertakes an in-depth country study and exploits the available qualitative and quantitative information. This paper uses a qualitative triangulation approach based on the subjective judgments of donors and recipients to assess aid effectiveness in Bangladesh. It focuses on the contributions of three major, high-profile donors: the World Bank, the Asian Development Bank (ADB), and the Government of Japan (GOJ).

The paper begins with a discussion of the importance of foreign aid to Bangladesh as it has evolved over time. This is followed by a critical evaluation of the economic and social impact of aid based on both donors’ and the recipients’ assessments. The paper then discusses the causes of aid ineffectiveness. As this theme has a wider resonance beyond Bangladesh, the discussion next turns to the experiences of the developing world as a whole. Recommendations for
making aid more effective aid follow, and the paper ends with some concluding remarks about the future role of foreign aid in Bangladesh.

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INTRODUCTION

From a precarious beginning, Bangladesh has achieved notable progress in economic and social development in about four decades. When it became independent in 1971 following a bloody war, many were skeptical about the country’s long-term economic viability. Some observers predicted a state of perennial aid dependence, while others referred to it as a “test case of development” (Faaland and Parkinson 1976), implying that if a country with such gargantuan and myriad of development problems as Bangladesh could make development happen, then perhaps any country could.

Despite the naysayers’ gloomy predictions and the widely shared pessimistic outlook, Bangladesh has made significant economic and social strides in the last three decades or so of its existence: it is no longer considered a basket case. Notwithstanding its large population, the country has achieved a measure of food self-sufficiency (although the food-population balance remains precarious). In the face of low per capita incomes and widespread illiteracy, it has made successful strides toward demographic transition and reduced its population growth rate from 2.5 percent per year in the 1980s to less than 1.5 percent per year in 2005 (Bangladesh Bureau of Statistics 2007b). In a number of other social indicators, such as infant mortality, life expectancy, primary school enrollment, female enrollment in school, and adult literacy, Bangladesh has made considerable improvements over the years. With respect to many

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¹ During the liberation war of Bangladesh, Henry Kissinger, the then U.S. secretary of state, is said to have famously remarked that Bangladesh was going to be a “basket case” and be permanently dependent on foreign aid.
Millennium Development Goals (MDG) indicators,² it now compares favorably with India even given the latter’s higher per capita income, higher growth rates, and higher social expenditures per capita (ADB 2006). Nevertheless, despite this success, Bangladesh is still at a rudimentary stage of economic and social transformation. It is still one of the poorest nations of the world which has still many human-development challenges to contend with. In the human-development index of the United Nations, Bangladesh ranked 146 among 178 countries in 2009 and was placed in the ‘medium human-development” category. As Sachs (2005, p. 14) correctly notes, Bangladesh has barely managed “to place its foot on the first rung of the ladder of development.”

Economic development happens in most places largely because of domestic efforts, which seems to be case in Bangladesh as well. As the past experience suggests, whatever little the country has achieved, it was largely driven by domestic efforts. And as was the case in the past, Bangladesh’s future success will depend largely on the quality and quantity of such efforts to meet the emerging challenges. Nevertheless, this process can be facilitated by external assistance in augmenting the availability of investible resources, providing policy advice, and improving institutions.

As development theory and empirical experience from developing countries suggest, external assistance can fill in for lacking resources by: (a) augmenting limited domestic savings, (b) providing the additional foreign exchange required to finance critical capital requirements and imports of raw materials, and (c) assisting with the development of human capital and the

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² The MDGs are a set of development targets aimed at eradicating extreme poverty and hunger; achieving universal primary education; promoting gender equality and the empowerment of women; reducing child mortality; improving maternal health; combating HIV/AIDS, malaria, and other diseases; and ensuring environmental sustainability. These targets, to be achieved by 2015, were set by members of the United Nations during its millennium session in 2000.
promotion of domestic capacity. However, as recent history indicates, frequently these potential benefits of external assistance have not been realized, and instances of aid ineffectiveness appear to be as numerous as instances of aid effectiveness.  

Aid can be ineffective for many reasons. Aid can be ineffective if it is too small or too much in quantity in relation to the country’s need. If it is too small and erratic, it may not have any significant impact on the country’s economy. If it is too large, it can also lead to various economic problems. If it is too large, it can hit the country’s absorptive-capacity constraint, leading to delays and inefficiencies in aid utilization. In addition to these inefficiencies, a large inflow of aid may lead to such economic pathologies such as the Dutch disease—that is, the flow of aid causing an appreciation of the real exchange rate and thereby impede the expansion of exports and growth of income. Similarly, an easy availability of aid can obviate the incentive for undertaking genuine reforms and making hard choices, thereby perpetuating bad policies, poor governance, and endemic corruption. However, poor policies can also emerge from the donors’ initiative as well. The donor agencies often take a non-discriminatory cookie-cutter approach to policies and institutions; when such one-size-fits-all policies are imposed on poor countries as part of the aid package, they can be out of synch with the requirements of the economy, thereby thwarting economic development.

This paper provides a critical review of aid effectiveness in Bangladesh (for earlier accounts of foreign aid and its impact on economic development in Bangladesh see Islam 2003 and Sobhan

3 The term “aid effectiveness” is largely self-explanatory. It refers to the effectiveness of foreign assistance in promoting economic development. However, as the perspective on development has evolved over the years, so has the meaning of aid effectiveness—the goals that the international community seeks to achieve through foreign assistance. The objectives of economic development have varied over the years—from increasing savings and investment to raising economic growth and per capita income to reducing poverty in its multi-dimensions. In recent years, the international development agencies have come to equate aid effectiveness with attaining the MDG goals.
It focuses on the contributions of three major, high-profile donors: the World Bank, the Asian Development Bank (ADB), and the Government of Japan (GOJ). In assessing aid effectiveness, the paper uses a qualitative triangulation approach based on the subjective judgments of donors and recipients. This approach is dictated by the deficiencies of the currently available quantitative methods for this purpose and the lack of adequate and reliable quantitative data. Those familiar with recent empirical literature on aid effectiveness are aware that the regression-based cross-country literature has created more confusion than conclusions and produced few robust empirical results (Quibria and Murshid 2007; Rajan and Subramanian 2005a; Roodman 2007). In addition, this method has little or nothing to contribute when it comes to the question of aid effectiveness in individual countries. Finally, in recent years, the method of randomization is being increasingly applied to assess the impact of individual (micro-level project) interventions; it has its own limits as a scientific method for drawing conclusions or deriving policy lessons⁴ (Deaton, 2009). Given the manifest shortcomings of the current rigorous empirical methods, it seems that a more productive approach to study aid effectiveness at the macro-level is undertake in-depth country studies, exploiting the available qualitative and quantitative information.

The next section of this paper discusses the importance of foreign aid to Bangladesh as it has evolved over time. This is followed by a critical assessment of the economic and social impact of aid based on both donors’ and the recipient’s perspectives. The paper then discusses the causes

⁴ The problem with the method of randomization has been most succinctly summarized by Deaton (2009, p2), who noted, “in ideal circumstances, randomized evaluations of projects are useful for obtaining a convincing estimate of the average effect of a program or project. The price for this success is a focus that is too narrow to tell us ‘what works’ in development, to design policy, or to advance scientific knowledge about development processes. Project evaluation using randomized controlled trials is unlikely to discover the elusive keys to development, nor to be the basis for a cumulative research program that might progressively lead to a better understanding of development.” Despite these shortcomings, the method of randomized evaluation has found favor with a segment of mainstream development economists.
of aid ineffectiveness. As this theme has a wider resonance beyond Bangladesh, the discussion next turns to the experiences of the developing world as a whole. Recommendations for making aid more effective follow, and the paper ends with some concluding remarks.

THE ARITHMETIC OF AID FLOWS

Bangladesh has received a sizable amount of foreign assistance over the years. Table 1 provides the data on total commitments and disbursements of foreign aid from 1971 through 2008. During this period, the country received about $48 billion of foreign aid, with an annual flow of aid that has ranged from about $1.0 billion to some $1.5 billion.

A number of features of the foreign aid inflow to Bangladesh may be noted. First, the composition of foreign aid has evolved over the years. Given the growth in agricultural productivity, the role of food aid has become virtually nonexistent as the economy has become more self-sufficient in food, a dramatic contrast from the period immediately after independence, when food aid played a significant role. However, because of the sizable pipeline from earlier commitments by donors, there is a flow of disbursements even in the absence of new commitments. Second, commodity aid was significant in the earlier post-liberation period. However, in recent years, both commitments and disbursements of commodity aid have fallen close to zero with no buildup of the pipeline. Third, in keeping with the general trend in

5 In 2008, Bangladesh was faced with a shortage of food supply due a number of adverse economic shocks, leading to a substantial food import. However, there are reasons to believe that this was more of a short-term blip than a long-term trend. Indeed, in 2009 agriculture output rebounded sharply with better weather and improved access to farm inputs. The long-term prospects are likely to improve further as agricultural innovations in the form of improved seeds and fertilizers become more widely available.
international development assistance, policy lending—both at the macroeconomic and at the sectoral level—has become an important, established part of the assistance program, and in some cases has supplanted simple project lending. This development has been accompanied by increasing economic and sector work—the so-called knowledge products—by the multilateral financial institutions. Nevertheless, despite the apparent increase in policy lending, data on policy lending are not readily available and the government is maintaining its old classification system that lumps both project and policy lending together under “project aid.” Fourth, given the lag between commitments and disbursements of aid—partly reflecting slow implementation of projects—the country has accumulated a significant pipeline which is almost 15 percent of the total commitments of external assistance.

TABLE 1. EXTERNAL AID COMMITMENTS AND DISBURSEMENTS


<table>
<thead>
<tr>
<th>Type of Aid</th>
<th>Grants</th>
<th>Loans</th>
<th>Total</th>
<th>Pipeline</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Food Aid</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Commitments</td>
<td>5,814</td>
<td>762</td>
<td>6,577</td>
<td>318</td>
</tr>
<tr>
<td>B. Disbursements</td>
<td>5,677</td>
<td>762</td>
<td>6,440</td>
<td></td>
</tr>
<tr>
<td><strong>Commodity Aid</strong></td>
<td></td>
<td></td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>A. Commitments</td>
<td>5,696</td>
<td>5,376</td>
<td>11,072</td>
<td></td>
</tr>
<tr>
<td>B. Disbursements</td>
<td>5,650</td>
<td>5,257</td>
<td>10,907</td>
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</table>
Fifth, even though official development assistance is still a significant source of foreign exchange, its importance has declined over the years as other sources of foreign exchange, such as exports and workers’ remittances, have picked up (Figure 1). In 1990, the flow of foreign development assistance exceeded the corresponding earning flows from exports and workers’ remittances; in 2008, the situation has changed dramatically, with total export-earnings and workers’ remittances exceeding the flow of foreign assistance by a factor of 10 and 6 respectively.

<table>
<thead>
<tr>
<th>Project Aid</th>
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<tbody>
<tr>
<td></td>
<td>A.</td>
<td>B.</td>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>A. Commitments</td>
<td>13,380</td>
<td>28,002</td>
<td>41,384</td>
<td>8,232</td>
</tr>
<tr>
<td>B. Disbursements</td>
<td>9,976</td>
<td>21,197</td>
<td>31,174</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>8,562</td>
</tr>
<tr>
<td>Total</td>
<td>24,891</td>
<td>34,142</td>
<td>59,033</td>
<td></td>
</tr>
<tr>
<td>A. Commitments</td>
<td>21,305</td>
<td>27,217</td>
<td>48,522</td>
<td></td>
</tr>
<tr>
<td>B. Disbursements</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Source: GOB (2009)</td>
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<td>12</td>
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In addition, as the economy has grown, the flow of aid as a proportion of gross domestic product (GDP) or a percentage of investment has declined over time. In the 1970s through the early 1990s, the net flow of aid as a percentage of GDP was more than 6 percent, but this declined to about 2 percent in 2005 (Figure 2). In the 1970s, soon after independence, external resources financed more than 70 percent of the country’s investment, but this had fallen to less than 10 percent in 2005 (World Bank 2007b). This reflects on the one hand the government’s relative success in mobilizing domestic resources and on the other, the increasing vigor of the private sector.

Source: Data from World Development Indicators (2007)
Note also that in recent years Bangladesh has received less foreign aid, as a percentage of GDP, than either heavily-indebted poor countries (HIPC) or other low-income countries (LICs) (Figure 3 and Figure 4). The data also indicate that the importance of foreign assistance to the economy, as a percentage of GDP or investment, has declined over time, though the absolute volume remains considerable.

6 A notable exception is, however, India, which given its recent vigorous economic growth and new-found confidence in its own economic capabilities, has decided to drastically reduce its dependence on foreign aid as a source of investment.
FIGURE 3. NET OFFICIAL DEVELOPMENT ASSISTANCE: BANGLADESH, HIPCS AND LICs (% OF GDP)

Source: IMF (2007)
The importance of aid as a source of investment has waned over the years. In recent years, aid has accounted for less than 10 percent of gross investment and financed a smaller proportion of total import bills compared to the 1980s or the 1990s (Figure 5). Despite this decline in the relative importance of foreign aid in the overall economy, the influence of donors in policy matters has paradoxically increased significantly. In recent years, the locus of donor activism not only encompassed the economy, but also transcended into the broader political and societal domains. Donor representatives are now found involved not only in the public discussions of technical economic matters but also in social and political issues—which in recent years included arbitrating in political disputes and arranging dialogues between two feuding “begums”, the leaders of two major political parties. While this arbitrary broadening of the mission of the donor activities—which runs counter to the charters of many of these organizations—may have sometimes yielded positive outcomes in diffusing political tensions in

Source: IMF (2007)
the county, it also held the potential of political backlashes if the outcomes run counter to popular expectations. Considering the pros and cons, the donor agencies would be well advised, from the perspective of their long-term effectiveness, to stick to their assigned mission, as enshrined in their charters.

FIGURE 5. FOREIGN AID AS A PERCENTAGE OF GOVERNMENT EXPENDITURES, PER CAPITA INCOME, IMPORTS AND INVESTMENT

Source: Data from World Development Indicators (2009)

Finally, the multilateral international financial institutions are the principal source of aid for Bangladesh, although the role of bilateral sources such the governments of Japan, the United
Kingdom, and Canada is also significant. In the early post-independence years, bilateral sources accounted for the bulk of the foreign aid the country received; however, by the early 1990s, the pattern began shifting in favor of multilateral sources, which now provide almost three times the amount of foreign assistance that bilateral sources offer. The two main sources of multilateral aid for Bangladesh are the World Bank and the ADB, which have provided assistance largely, though not exclusively, from their concessional windows. However, the terms and conditions of the International Development Association and the Asian Development Fund have somewhat hardened, and in addition, ADB is now classifying

The role of the US as a source of bilateral aid has declined significantly over the years, making it a marginal contributor to the country’s development process. (This bilateral assistance is received essentially through USAID, as the country is yet to qualify for grants from the Millennium Challenge Corporation.) In addition to its meager volume, much of the US assistance is channeled through non-governmental entities, preselected by USAID, a fact that arguably undermines the quality of its foreign aid. In short, the quality and quantity of US assistance to the country has declined over time.

Whether this shift in the sources of foreign aid improves the quality of external assistance has been the subject of much discussion. It is generally presumed that multilateral aid is more economic and less political with fewer strings than bilateral aid. Although this argument is apparently plausible, it does not seem to stand up to scrutiny. The political and ideological perspectives of multilateral donors are not too different from those of the bilateral donors, as the ownership structure of the multilateral financial institutions remains concentrated in a few major donors with similar political and ideological perspectives. In addition to the fact that the major bilateral donors are also the major shareholders of multilateral financial institutions, the donor agencies are also involved in continuous real-time ‘donor coordination’, thereby ensuring that everyone is on the same page with regard to policies and conditionality.

Another important source of multilateral finance is International Monetary Fund (IMF), whose loans are intended to address balance-of-payments problems. IMF provides special loans to low-income countries at a concessional interest rate under its Poverty Reduction and Growth Facility. While these loans are important, IMF does not make long-term loans for project financing like the multilateral development banks such as the World Bank and the ADB.
Bangladesh as a blend country—a country that borrows from both concessionary and nonconcessionary sources—which has contributed to the dilution of the grant element of the foreign assistance it receives.

Finally, as most of the foreign assistance the country receives is concessional, the buildup of debt has been slow. The total external debt, as of 2008, was slightly above US$20 billion, which was equivalent to about 26 percent of GDP and about 140 percent of export earnings (ADB 2009a). The majority of this debt—more than 90 percent—is long term, and total annual debt service as a proportion of export earnings was slightly higher than 5 percent in 2008. Compared with other developing countries, Bangladesh’s external debt is not high; it is well within prudential limits. It may be noted in passing that, as expected, debt indicators become somewhat worse when domestic debt is included in the calculus, although domestic debt has been relatively stable in the last few five years or so.

**ECONOMIC AND SOCIAL CHANGES SINCE INDEPENDENCE**

Since independence in 1971, Bangladesh has made significant economic and social strides despite the myriad challenges it faced in the forms of famines, natural disasters and political and social instability. After a tumultuous beginning in the 1970s, the economy started to stabilize in the eighties with steady growth and low inflation. Since the 1990s, GDP growth has since been strong, averaging over 5 percent per annum. The GDP growth rate further accelerated since 2001 when the average GDP growth rate reached nearly 6 percent. In terms of GDP per capita, the country doubled its rate of growth from 1.6 percent in the 1980s to more than 3.3 percent since the 1990s. In terms of per capita GDP, the growth rate compares favorably with other low-income developing countries or countries that borrow from the International Development Association (IDA) of the World Bank. What is remarkable is that this
acceleration in economic growth has been achieved in the face of significant reduction in foreign assistance per capita (from about $20 in 1990 to about $9 in 2008). Much of the domestic savings-investment gap is met by net foreign income in the form of workers’ remittances which have exhibited robust growth in recent years and amount to almost $9 billion dollars in 2008, which is six times of the amount of foreign aid the country received in 2007. In short, while there was a spurt in GDP growth in Bangladesh in recent years, there was a concomitant decline in the role and importance of foreign aid as a source of investment finance. This would seem to suggest anything but the critical role of foreign aid the macroeconomic dynamic of the country.

However, as is well recognized, the progress of a country should not be measured only through the metric of economic growth. Such a measure should take into account the impact growth on poverty and its contributions on improving the social indicators of the population. The following discusses the changes in poverty and social indicators in the country.

As noted earlier, the country has attained virtual self-sufficiency in food (except in times of natural disasters as in 2008). This increasing availability of food, along with rising per capita income, has contributed to a gradual reduction in poverty over the years. According to the latest available statistics (BBS 2007a), the incidence of poverty declined by 9 percentage points between 2000 to 2005. If the higher (national) poverty line is used, the incidence of poverty declined from about 49 to 40 percent of the population; if the lower poverty line is used, it declined from about 34 to 25 percent of the population during the same period. The corresponding data for the international dollar-a-day poverty was estimated to be 36 percent. However, as it is the case with many other developing countries, these figures are fraught with controversy, though few would disagree with the direction of change.

\[10\] In 2009, when there was a decline in the volume of remittances globally, the country has continued to post robust growth in remittances. According to the last data from the central bank, Bangladesh earned $10.72 billion in 2009, which represents a 20 percent increase over 2008.
Bangladesh has made impressive improvements in the last decade or so in key social indicators such as fertility, life expectancy, school enrollment for girls, and child immunization (Table 2), which compare favorably with other low-income countries, including its South Asian neighbors (with the exception of Sri Lanka). Bangladesh has successfully eradicated polio, which still infects some South Asian neighboring countries. Though child and infant mortality rates continue to be high, its rate of improvements has been faster than most low-income countries. These improvements in infant and under-five mortality had a significant, positive impact on life expectancy which went up by a decade within a short span of time. Much of this success in health-related indicators can be traced to higher priority the government accorded to health sectors. In addition to seeking higher amount foreign aid, it also channeled a greater amount of domestic resources to these sectors.

In the area of education, the country has achieved almost 100 percent enrollment ratio at the primary level, which is one of the highest in low-income countries. Bangladesh has already achieved one MDG—i.e., gender parity in primary and secondary education—and is on track to meeting several others (including halving poverty). Though Bangladesh has allocated lower amount of resources to education than its neighbor India, its allocation was more biased toward elementary education which may explain part of its success in achieving its high primary enrollment rates. In addition, both Asian Development Bank and the World Bank have provided targeted financial assistance-- which was in the form of conditional cash transfers-- to promote female education. Finally, Bangladesh has a vigorous NGO sector which has played a critical role in improving social indicators in the country including those in the areas of primary and female education. The country has had a notable success in reducing the fertility rate, a process in which the NGO sector played an important role by assisting the delivery of family planning services and by providing micro-credit to women. The access to micro-credit empowered women in household economic decisions, including in their reproductive decisions. Needless to say, microcredit has had some role in redressing rural poverty, particularly in addressing economic vulnerability in the face of economic shocks.
While Bangladesh has still a long way to go, these achievements in social indicators are extraordinary, given the fact that it is still a very poor country with limited resources for social expenditures. While the process was partly facilitated by the availability of additional resources that foreign assistance provided, establishing a causal quantitative relationship between aid and economic development in a rigorous manner has proved to be difficult. Thus rather than following this well-beaten but inconclusive track, this paper adopts a more qualitative approach. It takes a close look on qualitative evidence, drawn from the evaluations and assessments of donors and receivers, to draw conclusions regarding aid effectiveness in Bangladesh.

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<th>TABLE 2. SOCIAL INDICATORS IN BANGLADESH 1975-2008</th>
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<tr>
<td>Indicators</td>
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<tr>
<td>Gross Primary school enrollment</td>
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<tr>
<td>Male</td>
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<tr>
<td>Female</td>
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<tr>
<td>Gross Secondary school enrollment</td>
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<tr>
<td>Fertility rate</td>
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<td></td>
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<tr>
<td>----------------------------------</td>
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<tr>
<td>Immunization, DPT (% of children ages 12-23 months)</td>
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<tr>
<td>Immunization, measles (% of children ages 12-23 months)</td>
</tr>
<tr>
<td>Access to improved water sources (% of population)</td>
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<tr>
<td>Life expectancy at birth</td>
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<tr>
<td>Child malnutrition (% of children under 5)</td>
</tr>
<tr>
<td>Child mortality (per one thousand children under 5)</td>
</tr>
<tr>
<td>Infant mortality rate (per one thousand live births)</td>
</tr>
</tbody>
</table>

**Note:** a: latest single year

Source: Further revised by author based on World Bank (2007a)

### DONORS’ EVALUATIONS

Donors now undertake “independent” reviews of their programs through their in-house evaluation departments with some regularity. These reviews—which are essentially subjective and based on a set of predetermined broad criteria such as relevance, efficiency, efficacy,
impact etc.-- are important, as they provide the donors’ with evaluations of their own programs and performance. This review looks at three major donors to Bangladesh.\textsuperscript{11}

\textbf{THE WORLD BANK}

The World Bank is the largest as well as the most influential lender to the country. It is the coordinator of aid donors in Bangladesh. Since Independence, it has lent $12.5 billion to the country and played a critical role in shaping the country’s institutions and policies. For these reasons, the role of the World Bank is singularly important in any discussion of aid effectiveness in Bangladesh.

In the 1970s, during the initial phase of its operations, the World Bank concentrated largely on project lending for achieving food self-sufficiency, mobilizing domestic resources, improving social indicators, and enhancing project implementation. Even though over time the country attained varying degrees of success in all these areas, the pace of progress was slow in the 1970s.

During the next phase of its operations in the late 1980s, the World Bank focused on policy reforms to create an environment conducive to private sector development. These reforms were addressed at removing the distortions in trade, pricing, credit allocation, and interest rates. Once again, the efforts yielded mixed success. In its evaluation report, the World Bank attributed these mixed results not to any deficiencies in its own program, but to the government’s failure to implement reforms. Indeed, the World Bank went so far as to argue

\textsuperscript{11} Although the International Monetary Fund is an important source of external finance for the country, it was excluded from this review because its mandate limits its activities to maintaining macroeconomic stability, a role while important does not have a \textit{direct and immediate} bearing on economic development and poverty reduction. Similarly, we also excluded from this review the UN agencies, whose role, resource wise, is relatively small; and their activities are largely limited to technical assistance for capacity building.
that “a core constraint in the development process in Bangladesh was the government itself and its unwillingness to enforce the needed public sector reforms” (World Bank 1998b, p. 56).

To address the governance issues, the World Bank imposed more stringent policy conditions in the 1990s, but yet again, according to the World Bank, the government was less than forthcoming in its effort to implement these reforms. No doubt, part of the vacillation on the part of the government had to do with political economy constraints facing the government. But no less important was the widespread skepticism in the country, as elsewhere, regarding the intellectual basis of the reforms. While many of these reforms were discussed with the policymakers, they were unilaterally stipulated and imposed on the government.

The World Bank’s assessment about policy reform in Bangladesh was both disingenuous and self-serving. It was disingenuous in the sense that, as the international experience suggests, changing policies or institutions is a gradual, evolutionary process; it is difficult to superimpose externally from above. It was self-serving because the World Bank heaped all the blame on the government, but part of the responsibility must lie with the World Bank for proceeding without a thorough analysis of Bangladesh’s political economy constraints and for imposing conditionalities that were unrealistic and beyond the government’s capacity to deliver.

The late 1980s and the 1990s were a time when the international organizations as a whole pushed policy lending to bring about expeditious policy changes. This effort largely failed for various reasons. First, much of this lending often involved excessive conditionalities (i.e., policy changes attached to policy lending) that were beyond the implementation capacity of recipient country. Second, it was based on a cookie-cutter approach grounded in the Washington consensus—that is, on privatization, liberalization, and stabilization—with insufficient analysis. Finally, it imposed policy conditionalities with the “agreement” of the bureaucracy, excluding...
the larger society, even the parliament. The consequence has been inappropriate policies, weakened democratic processes, and poor economic outcomes.

During the current decade, governance has become the principal emphasis of the World Bank assistance program in Bangladesh; other areas of focus include human resource development, environmental management and gender equity, integrated rural advancement and private-sector growth by strengthening the financial sector and promoting private investment in energy, infrastructure, manufacturing and services. While no formal assessment of this assistance program is available to this date, it seems the results have been mixed. In the areas of governance, while the government has done reasonably well in macroeconomic management or coping with natural disasters, its performance has been weak in public finance management, tax collection, procurement and financial controls. In the areas of human resources development, the education and health sectors are beset with many serious issues, including the poor quality and efficiency of service delivery. Even though it is a priority area, rural development has received meager attention on recent World Bank lending. In the area of private sector development, much remains to be done. To facilitate private sector development, the serious bottlenecks in physical infrastructure—such as electricity, power and transport—need to be urgently addressed. Similarly, the financial sector remains fragile with large debts owed by state enterprises. Opening and operating business is riddled with many challenges, which include various types of extra-legal payments and political coercion. In the area of environment, Bangladesh faces many challenges, the most immediate and pressing being the management of water resources and air quality and pollution. In the area of gender, the World Bank’s projects and programs had a direct bearing on reducing gender gaps in school enrollment and promoting income-generating activities.

The World Bank considers its assistance program to Bangladesh effective even though the evaluation statistics point to a mixed outcome. The Bank evaluation of the outcomes of the existing portfolio of projects in Bangladesh from 1995-2007 compares favorably with those for the Bank-wide average as well as for the South Asia region. This result contrasts with the results for the earlier period. According to the earlier country evaluation report (World Bank 1998b),
the percentage of Bank projects that were deemed unsatisfactory was higher than the Bank-wide average. With regard to sustainability, the performance of projects in Bangladesh was unfavorable, as many had negligible institutional impacts. Lending to Bangladesh was deemed inefficient, as loan-processing required more time than the Bank-wide average. This poor project implementation performance no doubt reflected the country’s capacity constraints, but at the same time, this was not entirely a domestic problem; some of the issues stemmed from the multiplicity of donors with diverse reporting and accounting requirements that made heavy demands on scarce domestic managerial capacity. Recent years have some improvements in the implementation capacity of the government as well as some harmonization efforts on the part of donors.

**THE ASIAN DEVELOPMENT BANK**

The Asian Development Bank is the second largest lender to Bangladesh after the World Bank. Between 1973 and end of 2008, its total lending to the country amounted to about $10 billion, covering many sectors of the economy. However, the principal focus of ADB lending was in agriculture, energy, transport and education. In many ways, the findings from ADB’s evaluation of its country assistance program are similar to those of the World Bank.

Like the World Bank, ADB (2003) considers its program to be relevant and successful in a number of areas. These areas include support to agriculture to achieve the objective of self-sufficiency in food. Similarly, ADB considers its assistance in the energy and transport sectors to have been beneficial and to have made a significant contribution to the growth of GDP in the

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12 International aid agencies have recently recognized that part of the implementation problem stems from donors’ diverse procedures and standards and are working toward harmonizing these procedures and standards and aligning them with countries’ own systems. To date, some progress has been made but much remains to be done.
late 1990s. However, it considers its initiatives in the areas of agriculture, forestry, and the social sectors—particularly health and education—have had little impact on poverty. Interestingly, ADB (2003) does not attribute this lack of success to the general slowdown in poverty reduction Bangladesh experienced in the 1990s (due to shifts in income distribution), but to the lack of alignment of its program with the so-called Partnership Agreement on Poverty Reduction.13

Like the World Bank, ADB holds the government responsible for its failure to implement policy reforms, and hence, for the failure of ADB’s policy lending to the country. ADB, however, traces this failure to vested interests opposed to policy reform, without however, specifying what to do about the problem. In particular, ADB cautions against policy lending for capital markets and railways, because “governance issues are entrenched, and commitment to reforms has been lacking.” ADB also suggests reducing its involvement in sectors where “sector

13 The Partnership Agreement on Poverty Reduction was the ADB equivalent of the World Bank’s Poverty Reduction Strategy Papers (PRSPs). ADB subsequently discarded this initiative at the behest of the International Monetary Fund and the World Bank, which introduced the PRSP process in 2000. This process obliges the low-income countries (however, some exceptions were made for large countries such as India) to prepare national poverty reduction strategies as a condition to receive foreign assistance. The governments, in collaboration with World Bank and International Monetary Fund staff, are required to prepare these national strategy documents to promote growth and reduce poverty. These strategy documents should include countries’ macroeconomic, structural, and social policies and programs, along with their associated external financing needs. According to the World Bank, these papers are guided by five core principles: (i) they should be country driven, involving the participation of civil society and the private sector in all operational steps; (ii) they should be results oriented, focusing on outcomes that benefit the poor; (iii) they should be comprehensive in recognizing the multidimensional nature of poverty; (iv) they should be partnership oriented, which involves the coordinated participation by development partners (bilateral, multilateral, and nongovernmental); and (v) they should be based on a long-term perspective for poverty reduction. For details see World Bank and International Monetary Fund (2005).
performance has been poor, the potential for catalyzing impact is limited and ADB has no comparative advantage” (ADB 2003, p. v). This evaluation recommends limiting assistance to sectors where success has been limited. If this strategy were followed, subsequent ADB activities in Bangladesh would have been severely limited to a few sectors, and policy lending would be avoided.

In a recently completed subsequent evaluation of ADB (2009b), it found its recent aid program well designed and consistent with the government priorities. However, though the earlier evaluation recommend focusing the program to a fewer sectors, the actual operation became more expanded and diluted in recent years. It provided assistance to such divers sectors as energy, transport, education, disaster-management, agriculture, urban development and sanitation, law, economic management and public policy. Despite the broadening of the focus, ADB found more of its projects and programs successful (79% between 1999-2008). However, even though more projects and programs were deemed successful, its disbursements remained lower than the Bank-wide average and its contribution toward the country’s long-term development, as measured by the monitoring indicators adopted in its so-called results framework.

THE GOVERNMENT OF JAPAN

Japan is the largest bilateral donor to Bangladesh and accounts for a sizable portion (about 14 percent through FY 2008) of the country’s foreign assistance (GOB 2009). Its total aid disbursements during this period exceeded the combined total for the US and the UK. Japan implements its aid programs through a number of government agencies—the embassy, JICA, Japan Bank for International Agencies and Japan External Trade Organization. The stated objective of the Japanese country assistance program is to support Bangladesh to achieve economic growth, social development and human security (including health, education, gender equity and environmental protection) and governance. The actual assistance program included financial and technical assistance in a whole host of areas such as physical infrastructure,
agricultural development and social sector at a highly concessional rate. In the area of physical infrastructure, Japan has done more than any other donor and indeed taken a lead role in financing a number of high-profile bridges such as the Jamuna, Rupsa and Padma bridges.

The recent country evaluation by JICA (2004) found that its program was by and large consistent with country priorities as expressed in the Five-Year Plan and the Poverty Reduction Strategy Paper (PRSP) (even though, JICA had little involvement in gender and governance issues). It noted certain deficiencies in program formulation, coordination, and implementation from the Japanese side.

JICA has directed a large chunk of its assistance to rural infrastructure and agriculture, which experienced significant productivity growth. Nevertheless, the country evaluation concluded that it was hard to decipher and disentangle the contributions of Japan’s assistance in the macro indicators, because of the short gestation period (with respect to the evaluation) and the relatively small amount of aid in relation to total investment in the economy. The social sector is another area which received significant Japanese assistance. It is in this sector that the evaluation could discern more concrete results, particularly in the health sector. Prospectively, JICA hopes that the impact of Japanese aid will be more discernible as its assistance for construction and maintenance of major bridges and its technical cooperation in the fields of power and infrastructure development begins to bear fruit.

Summing up: Thus, from the donors’ perspective, aid effectiveness has been mixed in Bangladesh. Donors consider their investment projects to have been more successful than their policy loans. In the area of investment projects, the performance of Bangladesh has improved over the years, although there are persistent concerns regarding implementation delays and development impact. In the area of policy loans, the country’s failure to implement policies is not particularly unique to Bangladesh. However, many high-performing economies of Asia such as China and India have either totally avoided policy loans or have been highly discriminatory in accepting them. This reflects a desire to exert a degree of autonomy in formulating their own policies.
THE CITIZENS’ EVALUATIONS

There is no formal evaluation of aid effectiveness on the part of the government. However, there is no dearth of evaluations of the effectiveness from various nongovernmental sources such as the academia, the media and the civil-society organizations. In 2006, the Center for Policy Dialogue, a premier think-tank of the country, organized a policy seminar on aid effectiveness which was attended by senior civil servants, economists, the media, and business leaders. The seminar, which represented diverse segments of the society, discussed the problems with the existing aid programs, which lead to such mixed results. While the comments of participants were largely subjective, they highlighted the important shortcomings as perceived from the recipients’ perspective. The following is a sampling of the views expressed by the participants (Center for Policy Dialogue 2005):

(i) The donors have a disproportionate influence on policies: While the significance of aid in relation to the macroeconomy of the country has been on the decline for some time, the influence of donors in shaping and determining the policy agenda seems be on the increase. This disconnect between the financial contributions and the policy influence of donors creates to a policy agenda that does not reflect the priorities and aspirations of the citizenry and is at odds with the broader requirements of the macroeconomy.

(ii) Conditionality is limiting the policy autonomy of the government: Multilateral aid is not always based on pure economic considerations. It is usually delivered with a wider variety of conditionalities that constrict the policy autonomy of the government.
(iii) The disjunction between the benefits of adjustment loans and the costs of adjustment acts as a disincentive to implement reforms: Adjustment loans have an inherent incentive-compatibility problem. There is an incentive for the government to contract a policy loan as it provides relatively easy budget support. However, the costs of policy-adjustments are borne by sector ministries, which are not the direct beneficiaries of the augmented foreign assistance; consequently, there is often a lack of enthusiasm in the sector-ministries to implement the stipulated reforms.

(iv) The reforms should be home-grown and vetted by parliament: Currently, most reforms are exogenous and superimposed as part of the aid package, a process which explains their lack of ownership of reforms in the country. To foster ownership, the reforms should be generated endogenously within the country; such reform ideas can emerge from within the respective ministries or by independent commissions invested with the responsibility of proposing reforms. Such reform ideas could subsequently be discussed by the broader civil society and vetted by parliament.

(v) Donors have had little impact on poverty reduction in the country: The donors have made little direct contribution to poverty alleviation in the country. Except for Food-for-Works, all successful programs with a direct bearing on poverty reduction were home-grown. However, the donors have often assisted the process of poverty reduction by not radically trimming down social expenditures under adjustment programs.

(vi) There should be more aid to higher education: A country like Bangladesh which is poised to move to the next higher stage of economic development requires foreign assistance in higher education for enhancing skill-formation and promoting innovations. However, this is one area where donors’ priority and assistance has been conspicuously lacking.

(vii) Reforms are not owned because they are imposed: Bangladesh, like many other developing economies at a similar stage of economic development, requires foreign assistance both for budgetary support as well as for infrastructure development. Given the dire need for additional resources, the country accepts any offer of assistance without
much discrimination, even with dire conditionalities. This explains the lack of ownership of many reforms as well as the absence of enthusiasm in their implementation.

(viii) The PRSP is a poor substitute for planning. The PRSP has virtually replaced the long-established planning process that used to the practice in the country. It is an inadequate substitute for the overall planning of the economy envisaged in traditional five-year or long-term planning documents. The PRSP has emerged as virtual a wish list.

(ix) Donor policies are inappropriate: While some policies advocated by donors are good in theory, they are often formulated in the abstract without considering the political-economic realities of the country. As a consequence, it is difficult to implement these policies because they are not easily acceptable by society. Thus, even if the first-best policies are considered the most desirable, the second-best policies are the only ones that are feasible in practice.

(x) The Washington-consensus has yielded few benefits for Bangladesh: Donors have usually taken a cookie-cutter—one-size-fits-all—approach to policy formulation. This approach is based on the blueprint of the Washington-consensus of policies with emphasis on privation, liberalization and stabilization. Donor agencies have often advocated policies that pushed undiluted privatization rather than advance the development of the private sector; forced immediate and wholesale liberalization rather than advance gradual adjustment, and coerced countries into deregulation rather than support regulatory redesign. As the recent experience suggests, these policies have not produced any major breakthroughs in economic growth or poverty alleviation.

In short, the foregoing comments suggest that aid has been less than effective and has had little direct impact on poverty reduction; that it has led to a plethora of inappropriate policies imposed exogenously by donors who have exerted a disproportionate influence on policies that were neither owned by the country nor went through the usual democratic vetting mechanism;
and above all, that the PRSP exercise, which was artificially imposed by donors, has few indigenous roots and has helped undermine the traditional planning mechanism.  

AID EFFECTIVENESS ISSUES

The foregoing discussion highlights a number of issues that seem to have influenced the effectiveness of foreign assistance in Bangladesh. However, these issues are not in any sense unique to Bangladesh, but have a wider relevance. In light of the generic nature of these issues, the following discussion is posited within a general framework that draws on, and is informed by, broader international experience.

ABSORPTIVE CAPACITY CONSTRAINTS

14 India refused to go along with this process and asked the World Bank to anchor its assistance program to the country’s Five-Year Plan. In the case of Bangladesh, the PRSP has virtually replaced the Five Year Plan which has become practically defunct. In the absence of such a plan, the medium-term budgetary framework reported in the budget has turned into “a summary reflection of CAS (country assistance strategy of the World Bank) containing just enough to meet the enquiry of IMF and WB.” (Rahman 2008, p14). In other words, the country’s own planning framework has been supplanted by the country assistance strategy of the World Bank, rather than the other way around. It has become a case of the tail wagging the dog!
It is widely held by economists that developing countries suffer from absorptive capacity constraints, that is, there are limits to the amount of foreign assistance they can productively utilize. This idea of absorptive capacity constraints in developing countries dates back to the fifties and sixties (see, for example, Chenery and Strout 1966; Millikan and Rostow 1957; and Rosenstein-Rodan 1961) and is based on the presumption that most developing countries face serious bottlenecks in human capital and physical infrastructure. These bottlenecks lead to diminishing returns to aid; that is, the returns from foreign assistance decline as the flow of aid increases (for a review of this literature, see Quibria and Murshid 2007).

How binding is the absorptive capacity constraint in the case of Bangladesh? While there is no available direct measure of this absorptive capacity, it is indirectly reflected in the annual portfolio performance reviews carried out by donor agencies in the form of delays in implementing projects and in achieving sufficient development impact. In the case of Bangladesh, donors have documented numerous issues in relation to the implementation of projects and programs in their evaluation reports and annual portfolio reviews. These reviews suggest that the pace of implementation of projects in Bangladesh is usually relatively slow, though the disbursement performance of some donors is better than others. For example, ADB’s disbursement performance has been traditionally worse than those of other major development partners, though it seems to have improved in the last couple of years. The pace of implementation of the World Bank portfolio appears to have been somewhat faster than those of other donors, even though it has projects in its portfolio with questionable development impact and long-term sustainability. While all these indicate implementations issues, it is difficult to apportion blame between the donor and the recipient—because it takes two to tango.

No doubt, some of these issues reflect the country’s human resource constraints and bureaucratic bottlenecks, which can be resolved by greater investments in human resources and improving the existing institutional framework. However, not all the blames lie with the

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15 Some of the institutional mechanisms that donors have introduced to circumvent the absorptive capacity issues have their own drawbacks. One such institutional mechanism is the
recipient. Many of the problems stem from the cumbersome policies, procedures, and practices of donor agencies. An explicit recognition of these problems is found in ADB (2009b, v), which indicates “inefficiency in ADB’s disbursement procedures” and issues in “procedures for project implementation and design”. Given that each donor has copious reporting demands and insist on their particular ways of doing things, this leads to a magnification of the bureaucratic burden, much beyond the carrying capacity of most poor countries, as highlighted by Easterly (2003).16

In the case of Bangladesh, there is an active agenda of donor coordination and harmonization

REAL EXCHANGE RATE APPRECIATION

Whether through binding capacity constraints or diminishing competitiveness, the effectiveness of aid can decline as its volume increases, suggesting a nonlinear relationship between aid and growth. Even if one accepts that the impact of aid is subject to diminishing returns, the possibility is moot for most aid-recipient countries, as the point at which aid starts to have a

project implementation unit (PIU), which coordinates, manages, and implements foreign-financed projects. While these units have in many instances helped to circumvent some of the implementation issues and fast-track the process, they also have produced some unintended consequences. They tend to create new vested interests, whose incentives often diverge from the parent ministry and the government; given their artificial and isolated existence, they make little or no contribution toward domestic institutional development. In light of these adverse consequences, the PIUs appear to be increasingly losing favour with the development community.

16 An interesting account of the bureaucratic rigmarole surrounding the delivery of foreign assistance is found in Easterly (2003a).
negative effect on growth is much higher than the levels of official development assistance currently available to most low-income countries.\textsuperscript{17}

According to Rajan and Subramanian (2005b), the key to understanding weak associations between aid and growth is the real exchange rate overvaluation associated with any large windfall, that is, the so called Dutch disease.\textsuperscript{18} The mechanism through which Dutch disease operates is straightforward. An inflow of foreign aid leads to an increase in expenditures on nontraded goods. This increases the prices of goods and services produced in the nontraded sectors as well as the prices of domestic inputs that are used to produce them. This erodes the competitiveness of those export sectors that also depend on those nontraded inputs.

Why the mechanisms leading to real overvaluations should operate so strongly within developing countries is not clear. These countries typically produce far below their productive capacity, while the symptoms of Dutch disease arise when countries are producing close to their production possibilities frontiers (which preclude them from responding quickly to sudden increases in demand) (McKinley 2005). An increase in expenditures following an inflow

\textsuperscript{17} The total flow of aid to low-income countries (those whose annual per capita income is less than US$825) was US$34 billion (in current dollars) in 2004, compared with $44 billion in total workers’ remittances that same year. This flow of aid translates to less than US$15 per capita and about 2.8 percent of the aggregate gross national income of low income countries (World Bank 2006).

\textsuperscript{18} In recent years, a number of studies—which include Adenauer and Vagassky (1998), Nyoni (1998), Vos (1998), Vos and Johansson (1994), and White and Wignaraja (1992)—have analyzed the Dutch disease effects of aid inflows. If there is any common message from these studies, it is the absence of a consensus regarding the impact of aid on real exchange rate overvaluations and the competitiveness of export sectors. In retrospect, this finding is not particularly surprising given that countries differ in their individual circumstances as well as in their ability to manage their exchange rates.
of foreign aid may therefore have limited price effects in developing countries, which are usually characterized by high unemployment and idle capacity. Moreover, if foreign assistance is directed toward improving the economy’s productive capacity through investments in infrastructure, education, institutions, and health, this productivity increase could offset any potential loss of competitiveness resulting from Dutch disease (Adam and Bevan 2006).

However, a shortage of human capital and public infrastructure can cause severe bottlenecks in many developing countries, limiting their ability to absorb large amounts of aid. However, many developing countries suffer from a serious shortage of human capital and public infrastructure, which can limit their capacity to absorb any large amount of foreign capital. In these circumstances, this lack of absorptive capacity may lead to real exchange rate overvaluation and an erosion of export competitiveness; the factors that Rajan and Subramanian (2005b) argue are responsible for aid ineffectiveness. In such circumstances, rather than engendering the problem of Dutch disease, a properly targeted inflow of aid can help alleviate these absorptive-capacity constraints and enhance aid effectiveness.

In the case of Bangladesh, there is no evidence to suggest that foreign aid has led to a serious overvaluation of the real exchange rate and an erosion of export competitiveness. Indeed, compared with its neighboring countries, Bangladesh’s real exchange rate has become increasingly more competitive over time (Figure 4). Thus the apprehension that aid may cause Dutch disease and an overvaluation of the real exchange rate is unwarranted. What has really hampered the growth of exports has not been exchange rate factors, but the various supply constraints arising from physical infrastructure bottlenecks and skills shortages.
Rajan and Subramanian (2007) suggest that foreign aid has a negative effect on economic growth through its adverse impact on governance. They argue that as the volume of aid increases, it reduces the government’s accountability. In particular, the government slackens its efforts to maintain the rule of law, ensure predictable judicial outcomes, enforce contracts and

Source: IMF 2006.
limit corruption. As the quality of governance deteriorates, so does the growth of manufacturing, which is highly dependent on the quality of governance. While the above argument is plausible, it may not necessarily hold empirically. First, foreign assistance can be an important means of sustaining good governance and underpin economic growth. Improving governance requires substantial investments in physical and social infrastructure. Designing appropriate regulation and enforcing it, maintaining the rule-of-law, limiting corruption requires substantial investments in modernizing the police force, reforming the judiciary, educating and training the civil service, and providing the necessary physical equipment and modern information infrastructure. Building up a structure of modern and efficient governance requires a substantial investment which may not be forthcoming in the absence of substantial foreign aid. Thus, the relationship between foreign aid and the quality of governance is far from unilinear, as Rajan and Subramanian suggest. Second, it is argued that the metric for measuring aid effectiveness should be in terms of its impact on the welfare of the people, rather than economic growth. To the extent, governance is an important constituent of the welfare of the people, aid can provide the financial wherewithal to support an infrastructure of good governance and contribute to the welfare of the people. Third, even if governance has an instrumental role in promoting growth, the causality is far unilinear. There are empirical instances of countries where economic growth has been lack-luster despite their relative good governance; similarly, there are empirical instances of countries which have grown far more robustly, despite their apparent weak governance.

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19 One can also conceive of an opposite scenario, namely, foreign aid provides a country with the wherewithal to pay greater attention to governance issues, as many dimensions of good governance entail greater investments of resources in physical and social infrastructure. This may be the basis of the simple correlation between governance indicators and per capita income.

20 The relationship between governance and economic development is complex and multidimensional, which cannot be codified into a simple formula. See Dixit (2007) and Quibria (2006) for discussions of some of the underlying issues that can skew the relationship between governance and development and obfuscate the case for comprehensive governance reform.
As far as Bangladesh is concerned, Transparency International has ranked it as the most corrupt of countries for five consecutive years. Given that the Transparency International index is largely subjective, it is questionable whether such a precise ordering of countries is meaningful. Nevertheless governance, in particular corruption, is clearly a serious concern for Bangladesh. The immediate past army-backed caretaker government launched a campaign against corruption which helped, at least temporarily, to arrest Bangladesh’s further downward slide into corruption. Nevertheless, the extent and magnitude of corruption remains significant, and foreign aid is an important conduit of corruption. To the extent that foreign aid has indeed been a source of corruption, the culpability lies with both recipients and donors, as the aid delivery process—including procuring materials and awarding contracts and consultancies—is under the dual control of both donors and recipients. In an article that draws on Bangladesh’s experience, Rashid (2004) argues that foreign aid, rather than strengthening, has enfeebled government institutions by making them more porous and vulnerable to outside influences; this deterioration of the institutions renders them incapable of governing efficiently, thereby weakening their raison d’être.

The World Bank compiles a set of governance data that goes beyond corruption. These data are summarized under six broad categories: i) Voice and Accountability, ii) Political Stability and Lack of Violence/Terrorism, iii) Government Effectiveness, iv) Regulatory Quality, v) Rule of Law, and vi) Control of Corruption. They are available for the period from 1998 to 2008. Figure 7 shows the country’s percentile rank on one of the six governance indicators. Percentile ranks indicate the percentage of countries worldwide that rate below Bangladesh. Percentile ranks indicate better governance ratings. The graph also reports the margins of error displayed in the line charts by dashed lines, and corresponding to a 90% confidence interval. This means that there is a 90 percent probability that governance is within the indicated range. According to World Bank data, the overall quality of governance in Bangladesh has shown little or no improvement over time—indeed, some indicators have experienced some worsening (Figure 7
However, this apparent deterioration has had little impact on either economic growth or poverty reduction. This lack of correlation between governance and growth, which the World Bank (2007a) has labeled the Bangladesh conundrum, is not unique to Bangladesh, but is equally applicable to a number of high-performing economies, such as China, India, and Vietnam.
FIGURE 7. GOVERNANCE INDICATORS

Comparison between 2008, 2003, 1998 (top-bottom order)

Voice and Accountability
Political Stability
Government Effectiveness
Regulatory Quality
Rule of Law
Control of Corruption

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

A common complaint among donors is that policy conditionality has not worked in Bangladesh.\textsuperscript{21} However, this complaint is neither new nor unique to Bangladesh. Indeed, the World Bank’s (1998a) celebrated report Assessing Aid notes of a lack of a connection between conditionality and aid effectiveness in a wider context. The report talks about “a mountain of literature [that is skeptical] about the ability of conditionality to promote reform in countries where there is no strong local movement in that direction” (p. 51). In short, a sizable body of literature suggests that policy conditionality does not work. Although some recent changes have been made in the delivery of policy-based lending, much remains unchanged.

Policy conditionality is ineffective for many reasons.\textsuperscript{22} First, the donor and the recipient often have different views about the program. This divergence may not necessarily relate to primary

\textsuperscript{21} Traditionally, conditionality has focused on policy. In recent years, the scope of conditionality has been broadened to include the process of designing and delivering of aid. The process now involves broader segments of society so as to reduce corruption, foster respect for human rights, and engender greater accountability of the government to its citizens. However, the process conditionality often ignores the existing local political institutions that provide indigenous mechanism of accountability and emphasize western-style institutions. This often relies on internationally visible nongovernmental organizations over locally effective, low-profile organizations. In other words, the process condition is often predicated on donors’ assumptions and judgments regarding the quality and content of local political institutions—such as the nature of democracy, the degree of political openness and the extent of people’s participation. These are factors that are often hard to assess, let alone measure objectively.

\textsuperscript{22} The reasons may differ from country to country. Rahman (2008) provides an interesting personal account, based on his own experience as the top civil servant coordinating foreign aid resources of the country. He notes that, during his tenure, while Bangladesh government officials collaborated with donor agencies in the design of programs and reform agenda in such diverse sectors as jute, energy, railways, industries, telecommunication, health and education, the role and participation varied significantly from sector to sector. He also notes that though donors and recipients always agreed on the desirability reforms at the general
issues, such as the program’s content, but to secondary matters, such as the best means for achieving the program, the sequencing of actions, or the timeframe. Second, perhaps the most fundamental problem with policy conditionality is its dynamic time inconsistency problem. The recipient government may agree to a reform program prior to receiving aid, but it may renege on its promise as incentives change following the disbursement of aid. In other words, the issue of conditionality goes beyond designing an incentive-compatible contract in a static principal-agent framework. The interactions between donor and recipient are both dynamic and asymmetric, elements that make the relationship inherently more complex than standard static principal-agent problems. Third, other influences on the donor side tend to adversely affect the final attainment of conditionality. These relate to the incentive structure of donor agencies and the so-called Samaritan’s dilemma. Existing incentive systems in donor agencies place a high value on aid disbursement, which encourages aid officials to maximize aid disbursements even if this means overlooking the failure of conditionality. Such failures may also arise from compassion and the desire to help the poor in aid-recipient countries. However, while the poor may benefit from policy conditions in the long run, a trade-off often exists between relatively small short-term gains versus potentially larger long-term benefits. This can lead aid agencies to overlook the lack of fulfillment of policy actions in poor countries (Kanbur 2006).

The ineffectiveness of policy conditionality has elicited two different types of reactions. The first type—associated with Mosley, Harrigan, and Toye (1995), among others—has been to argue that conditionality works in theory, but that its application has been flawed in practice. According to this view, conditionality should be simpler, deviations from committed reform programs should be punished consistently, and a critical element for effective reform is country level, they often tended to diverge significantly on specifics. However, when it came to resolving the divergences, it is the donors who prevailed at the end. He goes on to conclude that while government participation enhances the probability of success of a reform agenda, it does not by any means guarantee it.
ownership. Country ownership has been defined in different ways, but it generally refers to a country’s commitment to pursue reforms independently of incentives provided by donors. However, the meaning of country commitment has varied from broad definitions to narrow definitions. Sometimes it is broadly interpreted to mean commitment by the entire recipient society—including the government, civil society, and the private sector—while at other times it may be narrowly defined to mean commitment only on the part of the government. Given the various senses in which the term country ownership is used, many, for example, Buiter (2004), find it to be an unhelpful and misleading concept whose time has passed. Nevertheless, despite the amorphousness of the concept, donor agencies have continued to stress the importance of country ownership, while at the same time they often tend to undermine ownership by maintaining various types of control over the design and implementation of reform programs. The World Bank, the International Monetary Fund, and other international donor agencies now build their respective aid programs for poorer countries around the PRSPs, an attempt to confer greater ownership to recipient countries.

The World Bank’s Operations Evaluation Department has set four key criteria for country ownership: (a) the locus of initiative must be in the government, (b) the key policy makers must be intellectually convinced, (c) the top political leadership must provide evidence of public support, and (d) the existence of broadly-based stakeholder participation must be apparent. Fostering country ownership therefore entails extensive government consultations with other segments of society, including civil society and the private sector. The putative purpose of such consultation is to elicit new ideas, knowledge, and opinions and to promote consensus on the strategy. As this definition involves large elements of subjectivity, any assessment of ownership remains largely subjective.

Stiglitz (1999) suggests that the role of donors in the design and implementation of reforms should be reduced from that of a dominant participant to that of economic advisers who only apprise countries of their policy options and associated pros and cons.

However, this attempt to bestow greater ownership has achieved only limited success. First, PRSPs continue to be mostly donor rather than country driven, particularly where domestic capacity to formulate such a strategy is lacking (Easterly 2006b). Second, even where such capacity exists, the PRSP process often turns into what Van de Walle (2005) calls an act of
The second type of reaction is to accept that traditional policy conditionality does not work and therefore needs to be abandoned. This point of view suggests a different type of conditionality that is tantamount to selectivity,\textsuperscript{26} that is, aid should be given to countries on the basis of ex post policies. This approach abandons the imposition of ex ante conditionality and argues that selectivity will ensure a superior outcome. In a “repeated game,” as long as the donor consistently rewards countries that demonstrate good policies with aid, it will elicit “good” behavior from recipients.

Gunning (2000) lists four frequent objections to selectivity. First, by definition, selectivity excludes countries with poor governance and unsound policies. This will exclude not only countries with malevolent leaders but also countries with enlightened leaders who are hamstrung not by a lack of will, but by a lack of institutional capacity to address governance issues (Barder and Birdsall 2006). Consequently, poor people living in those countries with weak governance who could potentially benefit from foreign assistance suffer. Second, countries with good policies can generate adequate domestic and foreign private investment without foreign assistance. Third, selectivity makes aid allocation contingent on the definition of good policies. While some aspects of good policy may be objectively defined, others involve subjective judgments resulting in little consensus on what constitutes good policies and results in ventriloquism— that is, when recipient countries present their PRSPs, they present precisely those programs and strategies that the donors favor in order to receive funds. Finally, as the PRSP process is a great strain on scarce resources, it should be abandoned in favor of the five-year plans that most countries prepare on their own.

\textsuperscript{26} In its traditional sense, a country receives aid on the basis of a promise to undertake a stipulated set of policy actions. In other words, conditionality entails a set of prior actions before the loan is disbursed, and is thus based on ex ante reform. Selectivity, by contrast, relates to ex post reform: aid is made available on the basis of the success of ex post reform. In practice, selectivity is combined with process conditionality.
bargaining between donors and recipients. Fourth, selectivity may conflict with ownership. This happens when donors attempt to provide detailed, multidimensional definitions of “good” policies that are inconsistent with the recipient government’s own development objectives.

Gunning (2000) considers the first two objections unsustainable. With respect to the first objection, he argues that poor people in poor countries will not in any case benefit from foreign assistance when the quality of governance is questionable. One way to circumvent this problem is to bypass the government and assist the poor through other conduits, such as nongovernmental organizations. With respect to the second objection, Gunning argues that even if policies are good, poor countries do not metamorphose into developed countries overnight. In the interim period, when domestic savings and foreign private investment remain limited, foreign aid continues to play a key role in the transformation process.

In sum, ex ante policy conditionality appears to be largely ineffective in practice; however, selectivity, which is now commonly used in conjunction with process conditionality, has also not proved to be as fruitful as originally anticipated. In view of this, to further enhance aid effectiveness, recipients need to be given greater real autonomy over the deployment of aid resources and the formulation of policies. This has led some authors, for example, Kanbur Sandler, and Morrison (1999) and Ranis (2006), to suggest that aid from all agencies should be pooled and allocated as lump sum transfers, with the recipient country given full responsibility for allocating it across sectors and for implementing projects without donor interference. Similarly, Barder and Birdsall (2006) propose a hands-off approach to foreign aid, which they call payments for progress. Under this proposal, foreign aid would be offered to poorer countries based on evidence of progress, which would be measured in terms of outcomes, and not policies and other intermediate inputs. They argue that this would give local institutions flexibility and autonomy, as well as space for institutional experimentation, while at the same time ensuring that aid pays only for real and measurable progress.
The choice of measure matters for aid effectiveness. Under current practice, the implicit metric the international community uses is some measure of recipient countries’ policies and institutions. The World Bank, for example, allocates aid largely on the basis of its country policy and institutional assessment index, which consists of 16 components grouped into 4 categories: macroeconomic policies, structural policies, public sector management, and social inclusion (for more information on recent changes to this index see World Bank 2005). Similarly, the success of policy-based lending is measured by the extent to which countries’ meet policy conditions. However, these are all indirect and convoluted ways of viewing aid effectiveness, which should instead be measured directly on the basis of economic outcomes. Indeed, many development practitioners have come to this conclusion in recent years and an intellectual shift in favor of outcome-based conditionality rather than policy-based conditionality is under way. Under outcome-based conditionality, donors focus on impacts and outcomes rather than on inputs, activities, and outputs.27 The European Commission has recently introduced a form of outcome-based conditionality for its adjustment aid to African, Caribbean, and Pacific countries (Adam and others 2004).

27 Inputs refer to the financial, human, and material resources used for a development intervention, for example, the budget used to construct schools or health centers. Outputs refer to the products, goods, and services that result from a development intervention, for example, the number of schools built and the number of health centers opened. Outcomes refer to intermediate indicators of results, such as the number of students who graduate from the schools and the number of visitors to the health centers. Impact refers to the long-term consequences of the intervention, for instance, improvements in health and education indicators. Given the difficulties inherent in distinguishing between medium-term outcomes and long-term impacts, they are often lumped together under the heading of outcomes.
The main arguments advanced in favor of policy-based conditionality, rather than outcome-based conditionality, are that policy changes are easier to observe and monitor and have greater incentive effects. Policies are more directly controllable by governments than outcomes and their implementation can be monitored more easily. Outcomes are not under the full control of governments and reflect a variety of influences, including negative exogenous shocks. Moreover, a long time lag often occurs between policy decisions and outcomes in terms of economic growth and poverty reduction. This combination of time lags and weak links between policies and outcomes can further dilute incentives for governments to undertake positive policy actions.

The main argument put forward for outcome-based conditionality is that it promotes greater ownership and accountability. Some observers, for example, Gunning (2000), argue that the current practice of donors undertaking detailed assessments of a country’s entire policy environment is unnecessary and tends to undermine ownership. As donors should be more concerned with outcome indicators and not the means for attaining them, governments should be given free rein to choose their policies, which would help promote ownership of policies and strengthen accountability, thereby enhancing private sector confidence.

The main argument against policy-based conditionality is that it is imperfect in the sense that it will not be able to achieve a first-best outcome. Drazen and Fischer (1997) identify three reasons for this. First, government policies are imperfectly observable. Second, results are not fully determined by policies but are also influenced by luck. Third, governments have varying degrees of competence that cannot readily be distinguished ex ante. In addition, a good deal of uncertainty—as well as lack of knowledge—surrounds the “results chain” that tracks the causation of a development intervention from inputs and activities to outputs, outcomes, and impacts.
At the same time, outcome-based conditionality is also fraught with practical difficulties. The indicators commonly suggested for outcome monitoring are GDP growth, changes in poverty, and changes in child mortality, but unlike for growth rates, current data on poverty and mortality are not always readily available. In addition, as most outcome indicators are likely to change only gradually, any meaningful impact assessment can only be undertaken after a number of years, plus such assessments may reward or punish a current government for the actions of a previous government.

In light of these difficulties, outcome-based conditionality that purports to monitor long-term impacts and medium-term outcome indicators may need to be selective and may have to be supplemented by output indicators and other indicators of intermediate results. Depending on the availability of data on different types of indicators, as well as the accuracy with which they can be monitored, the final choice may necessitate a mixture of output and intermediate result indicators, but not inputs.

DESIGNING A NEW AID FRAMEWORK

The current donor approach to foreign aid, which is based on the principles of ownership and selectivity, is an improvement over the past. Nevertheless, as the foregoing section highlighted, there are some generic issues with the current approach to foreign aid which need to be addressed to make aid more effective. The preceding section discussed some of those issues and argued for an approach that embodies greater flexibility in the delivery of aid, provides recipient countries with more policy space, and emphasizes results.

A new approach to foreign aid should include the following considerations: First, under the new international development compact, the principal consideration for allocating aid should be needs--the extent of poverty in its multi-dimensions, as reflected in MDG assessments as well
as the national plans. These documents, which should be coherently linked to each other, would define a country’s external finance requirements and development strategies.

Second, the current donor practice is to allocate aid based on performance—or selectivity. The World Bank uses its own subjective Country Policy and Institutional Assessment (CPIA) for this purpose. Other multilateral development banks use some variants of CPIA. If such selectivity is to be practiced, the performance criterion should not be subjective assessments of policies and institutions, but of actual economic and social outcomes. According to the MDG perspective, a country’s development performance would be measured in terms of its progress toward achieving the MDGs over a given time frame. When the data to monitor progress are not available, monitoring may be limited to a few strategic variables such as GDP growth, changes in poverty, and changes in child mortality.

Third, there is a tension between considerations of needs and selectivity in aid allocation. Allocating aid based on selectivity would imply focusing aid to a few countries that are doing well. Allocating aid based on needs would imply focusing aid to poorly managed, weak economies. The actual allocation principle can strike a balance between these two considerations, perhaps with more emphasis on needs (Bourguignon and Sandler 2007).

Fourth, as currently practiced, the bulk of effort in relation to aid effectiveness is anchored in a notion of “good” institutions and policies that aid agencies strive to foster across the developing world. This is done in two ways—through explicit conditionality in policy lending, which has proved to be a failure; through implicit conditionality imposed through performance-based lending. If aid agencies are interested in enhancing the effectiveness of aid, they should abandon this cookie-cutter approach. They should recognize that there is a wide diversity among countries in terms of their history and socio-economic constraints and there is no unique set of good policies and institutions that apply to all countries. Therefore, the countries should be given the space to design their own policies and institutions, based on their own requirements (UNCTAD 2006). If some countries lack domestic capacities to design their own policies and institutions, they can seek independent external expertise through the aid donors.
Fifth, a critical plank of the current aid approach is ownership, which has been formalized in the PRSP process imposed by the international donor agencies. This emphasis on ownership is correct. When a country is genuinely in charge of its development process, it can not only better identify with its policies and strategies, but can also bring local knowledge to work. However, by supplanting the national plan and substituting it with PRSP, the whole ownership concept has been reduced to a ventriloquist comedy in many countries. To foster ownership, in countries where national planning capacity and institution exists, PRSR should be discontinued in favor of such national plans, which truly reflects national goals and aspirations.

Sixth, the current framework does not pay adequate attention to county diversities and adopt a uniform, homogenous approach to aid delivery despite differences in their circumstances. Where there is a critical threshold-level of good governance, recipient countries should be given complete autonomy in planning their projects and programs and managing their aid resources without donor interference. In countries where the quality of governance is poor and the risk of resource diversion is high, aid can be channeled through reliable and efficient NGOS or can be limited to emergency assistance. In between there are countries which do not meet the governance threshold for autonomy but otherwise possess reasonably stable government, a middle-of-the–path approach should be followed: aid allocations should be limited only to areas where there is strict fiduciary oversight and efforts should be made to improve governance and strengthen public service.

Needles to emphasize, these measures by themselves will be insufficient to ensure aid effectiveness unless recipient countries adopt complementary measures. These complementary measures should be aimed at enhancing domestic capacity to implement sophisticated projects and creating an appropriate economic environment for the economy to flourish.
CONCLUDING REMARKS

Assessments of both donors and recipients suggest that Bangladesh achieved mixed results in aid effectiveness, although the country’s performance in utilizing aid seemed to have improved significantly in recent years. The mixed success of Bangladesh can be traced to shared failures on the part of both the government and donors.

Bangladesh aspires to become a middle-income country by the middle of the next decade if it can accelerate its pace of growth to 7.5 percent. Although the pace of economic development has accelerated in recent years, its effort to further accelerate the growth rate has been hampered by infrastructure bottlenecks; the inability to create a conducive policy environment that can spur rapid business growth; and the absence of an equitable, transparent, and accountable governance structure. It was earlier hoped that the advent of a democratic polity would be able to overcome some of the governance issue stifling economic dynamism. Even though Bangladesh made the transition from authoritarianism to democracy more than a decade ago, it continues to be a fledgling, illiberal democracy (Zakaria 1997). It has turned out to be a show of bickering “begums” and a “tyranny of the majority” (de Tocqueville 1969) that permits few genuine economic freedoms, spawns massive corruption and rent-seeking, and allows little space for economic talents to flourish. The governance problem was greatly compounded by the absence of enlightened leadership at the top with a grand vision of economic development and a sophisticated understanding of the development process, which are particularly germane in the current period of rapid globalization.

The governance issues notwithstanding, Bangladesh has attained a measure of success in many areas of the economy, thanks to entrepreneurial spirits and abilities of the ordinary people and the dynamism of a vibrant civil society. However, past success is no guarantee for future
success. The requirements of governance vary from one stage of development to the next, and many aspects of governance that were unimportant in the past are likely to become more critical as the economy makes the transition from a rural agricultural economy to an urban industry-cum-service economy. In making the transition, the country has to overcome the serious infrastructural challenges facing the economy and create an environment that fosters rapid private sector growth. In infrastructure development, both foreign aid and foreign investment can play a critical role, but for both, governance matters. With respect to foreign aid, there are serious concerns on the part of the donors on such matters as financial accountability, contracts and procurements and fiduciary oversight. Unless these issues are resolved, attracting new investments to infrastructure is likely to be difficult, thereby jeopardizing the prospects of further accelerating economic growth in future.

However, one hopes that given the tremendous political pressures that the government faces at the moment from the general public regarding various types of infrastructure bottlenecks—particularly, electricity, the government will be catapulted to action to redress these problems. If this forces the government to start paying attention to the various types of governance issues that thwart industrial progress, that may usher in a new beginning. In that changed context, foreign aid can be an enormous catalyst for economic development and poverty reduction. However, if the government dithers and fails to act, that may erode the hard-earned economic gains achieved by the country and lead to a path of unthinkable human tragedy that the early prognosticators of doom had imagined. The country is really on the razor edge.
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