6-1-2006

Toward the Enhanced Effectiveness of Foreign Aid

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CENTER DISCUSSION PAPER NO. 938

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June 2006

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Abstract

At the very time that professional skepticism concerning the effectiveness of foreign aid has reached new heights, donors seem to be ready to substantially increase the volume of aid they are willing to make available. This paper attempts to address this paradox by first examining the record of aid in the past, distinguishing between cross-country regressions and select country experience. It subsequently proceeds to propose the establishment of a new modus operandi for foreign aid, based on a much more passive, bankerlike posture by donors, leaving the initiative for defining what reforms are feasible, plus the establishment of self-conditionality, to third world recipients before they approach the international community of donors.

Key words: Foreign Aid, Development

JEL Codes: O11, O19

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I. Introduction

We are currently witnessing a general revival of interest in third world development as well as in the OECD countries' willingness to increase foreign aid allocations in support of development. Undoubtedly, this is in part a consequence of 9/11 and the interpretation by some rich countries that development, however defined, constitutes a possible antidote to the risks of terrorism supported by a third world in poverty. Yet, paradoxically, at the same time, skepticism on the very usefulness of aid has reached new heights. The literature on the impact of aid on development has clearly been mushrooming, but with increasingly sharp differences between a diminishing cadre of believers and an increasing band of critics. If there is any consensus, it is that the past record which may be summarized as "Structural Adjustment," or aid accompanying conditions enshrining the Washington Consensus, has not been a success. Current controversies oscillate between the Burnside and Dollar[1] position, that aid works only when domestic policies and, more recently, institutions, are receptive, to Easterly et al[2], Pritchett and others, who find few redeeming features in such transfers – all four, of course, to make things more interesting, having worked at the World Bank, the principal conveyor of aid.

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[1] "Aid, Policies and Growth: Revisiting the Evidence," World Bank Policy Research Working Paper 3251.

[2] "New Data, New Doubts: A Comment on Burnside and Dollar's 'Aid, Policies, and Growth'," W. Easterly, R. Levine and D. Roodman, American Economic Review, forthcoming

Perhaps the most devastating assault has been delivered by Rajan and Subramanian[3] who survey the cross-country cross-sectional literature and find little that is positive and significant for growth. On the other hand, Steven Radelet[4] at the Center for Global Development suggests that if we decompose aid, eliminate its humanitarian and very long term components from consideration, and focus only on the 53% which has a 4-year gestation period, the impact on growth can still be found to be positive. But even Burnside and Dollar whose 2004 refurbishing of an earlier piece, with the help of new data and the deployment of a new institutions index, come up with some positive results, have to concede that "a limitation of the cross-country approach is that they cannot definitively settle some debates."

At the outset, it is undoubtedly important to recognize that, unlike in the early post-war years, foreign aid today has only a limited overall role to play. Certainly in the middle-income and the so-called "emerging" developing countries, it has been completely swamped by private capital flows. However, it undoubtedly still has something to contribute in the poorer developing countries as represented by Sub-Saharan Africa, parts of Central and South America, and parts of South Asia. With respect to the middle-income countries, the main positive functions of aid would have to rest on its catalytic or qualitative impact, in terms of facilitating domestic behavioral changes as well as encouraging complementary foreign private capital inflows, all with the objective of the earliest possible graduation from public flows.

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[3] "Aid and Growth: What Does the Cross-Country Evidence Really Show," IMF Working Paper, #127, June 2005.

[4] "Counting Chickens When They Hatch: The Short-Term Effect of Aid on Growth," M. Clemens, S. Radelet and R. Bhavnani, Center for Global Development Working Paper, 2004.

Concerning both the possible quantitative and qualitative contributions of foreign aid, problems which stood in the way of effectiveness in the past must be understood if it is to be enhanced in the future. Section II examines those problems of the past in both middle and low income countries, while Section III suggests a set of possible remedies if we are to keep the baby usefully in the bath water. Section IV briefly concludes.

II. Problems of the Past

The basic question which clearly needs to be responded to at the outset is how developing country performance has been affected over the past 50 plus years as a consequence of the provision of foreign aid, multilateral and bilateral. If we accept the conclusion, based on the exhaustive cross-sectional econometric evidence presented by Rajan and Subramanian, the picture is indeed somber – virtually all the literature surveyed concludes that foreign aid has not had a significant positive impact on growth. Unfortunately, given the well-known weakness of cross-country regressions, there is very little help from rigorous comparative country studies pursuing interesting outliers, nor is there much effort anywhere at precise causal analysis. Nevertheless, these generally somber findings should give all of us pause in the very midst of the current revival of foreign aid allocations.

Turning first to the quantitative side of the ledger, there seems to be a substantial long-standing consensus in the literature that aid has usually caused a major displacement – though not necessarily one for one - of domestic savings, i.e. causing a reduction in domestic taxes and private savings. Everywhere, but especially in Sub-Saharan Africa where foreign aid has been relatively large, i.e. 13% of GDP on average, aid seems to have crowded out instead of crowding in private investment. This effect, though again causal analysis is hard to come by, has presumably been due in part to a preference for consumption and in part to the so-called "Dutch Disease," the narrow version causing a strengthening of the exchange rate via an increase in the spending on non-tradables and a decline in exportables, especially of the labor-intensive variety.

The larger problem, and the larger and more recent disappointment, undoubtedly rests with the failure of aid to have made a positive qualitative impact on recipient country behavior. Today, the general assessment, even by the major donors, including the World Bank, is that the provision of dollars cum advice, coupled with conditionality, has been generally ineffective. There are questions about the extent to which the policies suggested as part of those packages were really flexible enough to fit particular country cases, the extent to which the behavior of recipients was, in fact, affected in a positive way, and last, but not least, whether, in fact, aid ended up infecting recipients with a broader and more virulent strain of the Dutch Disease, one creating a scramble for the additional rents, causing increased corruption, a reduction in checks and balances, and generally impacting decision-making negatively.

The World Bank's own major evaluation reports of the 90's admitted to the many failures of structural adjustment lending because of the frequent absence of a true domestic constituency for reform.[5] Clearly, enhanced donor intrusiveness was not generally accompanied by a requisite understanding of the institutional and political economy dimensions underpinning recipient governments' reform commitments. All the Bank was able to claim is to have been "associated with" success at some project level

[5] See, for example, the summary effort "The Role and Effectiveness of Development Assistance" by Ian Goldin, Halsey Rogers and Nicholas Stern, The World Bank, no date.

efforts and to have “contributed to” some progress on reforms where balance of payments or budget support was offered. And yet we know that there are individual country successes in the past that should not be dismissed. The difficulty is with the ability to ascribe the success to foreign aid in a multi-cook setting.

Non-project policy or program loans were indeed not invented by the World Bank during its 1980’s – 1990’s Structural Adjustment era. U.S.A.I.D. in its 1950’s – 1960’s hey-day, for example, provided assistance to Taiwan, first in order to dampen run-away inflation in the 50’s and subsequently – in the early 60’s – to support the famous 19 Points of Reform, coupled with the announcement that economic aid would cease by 1965. We all know that Taiwan was one of those early success stories. Neil Jacoby’s[6] assessment of the dominant contribution of aid to that story may have been exaggerated and is certainly not econometrically supported, but the close collaboration between donor and recipient via the Joint Commission on Rural Reconstruction, plus the reliance on a decentralized set of signals from below, undoubtedly yielded major macro-economic and structural changes. There are other cases in the 60’s, and since, including South Korea, Chile, Bangladesh, Costa Rica and Poland which can be documented to the effect that aid, coupled with advice and real local ownership, yielded success. Perhaps the general malaise encountered today is less related to the inherent impossibility of a positive result at a country level and more to the problem of diminishing returns to foreign aid over time, coupled with a much enhanced recipient competence and the growing realization by both parties that they have all too often been engaged in a non-substantive ritual dance.

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[6] U.S. aid to Taiwan; a study of foreign aid, self-help, and development, Neil H. Jacoby, New York, F. A. Praeger [1967, c1966].

The list of the reasons for what is now generally admitted to have been the failure of Structural Adjustment is long. It runs from too much distance from principal to agent, with the principal lacking the necessary information and not relying sufficiently on bottoms-up information. It extends to one form of the collective action problem, given the increasing multiplicity of competing principals - leading to the proliferation of projects and ever higher transactions costs – including the inflation of visiting donor teams asking the same questions every year, of the same overworked local officials. The World Bank itself[7] reports that Tanzania recently had to produce more than 2,000 reports and endure 1,000 missions annually. The malaise also extends to the fact that 70% of aid remains tied, reducing its value by around 20%, and last, but by no means least, to the enhanced politicization of aid, in this post Cold War era, which even the most recent, initially promising innovation, the U.S.' Millennium Challenge Corporation (MCC), apparently has not been able to avoid.

In this latter context, it is worth noting that the March 6, 2006 U.S. National Security Strategy Memorandum focused on "using foreign assistance to support the development of free and fair elections, the rule of law, civil society, women's rights, free media and religious freedom." Unlike the earlier post 9/11 version, not a word on "development," not even on the currently popular "alleviation of poverty." At the same time there are organizational changes in the works in the two biggest donor countries, the U.S. and Japan, which seem intended to shift the overall management of foreign aid in the opposite direction, away from quasi-independent aid agencies and towards consolidation under one political roof, namely that of the State Department in the U.S. and the Office of the Cabinet in Japan. These moves would tend to define the world's

[7] Africa Development Indicators, 2002.

two biggest aid programs even more closely as instruments for advancing the donors' short-term foreign policy objectives. No foreign minister is able to resist the temptation to use such newly acquired large-scale resources in this fashion.

While, inevitably, country allocations are usually accompanied by appropriate rhetoric concerning development objectives, it is well recognized, at least by academics, that it is really not possible to serve two objectives with one instrument - witness the generous continuous annual U.S. aid flows to Egypt as a contribution to the "Middle-East peace process." The aforementioned U.S. Millennium Challenge Corporation, advertised as intended to be completely free of political interference, while basing its allocations on 16 objective performance criteria, had to reserve room for "exceptions," an escape clause which has already been used extensively to reward democracies and other friends abroad, with only 60% of the countries which passed the performance criteria test actually selected for funding.

But, over time, perhaps the most serious handicap in the way of all aid donors, bilateral or multilateral, has been the well-known so-called "disbursement dilemma," the overwhelmingly strong need to lend, accompanied by an overwhelmingly long list of conditions, often insufficiently differentiated to reflect specific local institutional, political, even economic realities. Such a laundry list of conditions, sometimes additive as between the World Bank, the regional development banks, the IMF and bilateral donors, was frequently assembled without necessarily a clear idea of what is really critical and what a country can reasonably be expected to accomplish from both the technical and political points of view. While the average number of conditions attached to country programs at the World Bank, for example, has, in response to criticism, been reduced from about 60 in the 1980's to about 30 in 2000, such a number is still unduly large in terms of the realistic implementation capabilities of most recipient countries. The critical sequencing of reform components, by no means a trivial issue, has also often taken a back seat, with levels of friction, disappointment and fatigue rising exponentially - especially once it became obvious to recipients that the need to lend would ultimately overcome the need to ensure that the laundry list of conditions had been at least partially met. But the real sticking point, most observers now agree, is the absence of a genuine internal agreement on what reforms are really needed and who is ready to bear the costs.

In summary, and at the risk of some exaggeration, what has usually taken place in the past in most of the major aid operations, has been a rather time-consuming and expensive ritual dance. Structural adjustment lending customarily has led to disbursement, with very few cancellations, or, at worst, a delay or two; few countries have ever had any prolonged breakdown in their relations with the donor community. And all this in spite of the fact, as reported by Tony Killick, that, in the early 90's, only a quarter of the World Bank's structural adjustment loans moved forward according to the agreed schedule.

Once both lender and borrower know that the commitment to a fast-disbursing loan has been made, it is difficult to maintain a credible threat of cutting off the resource flow in case of non-compliance. Even such non-compliance usually turns out to be a highly ambiguous concept since it comes down to a judgment call. Since everybody knows that the donors are likely to insist on compliance early on, but anxious to disburse later, both parties have an incentive at the end to fashion relatively superficial agreements and continue with the annual dance. Meanwhile, the additional resources which were supposed to ease the pain of adjustment accompanying the stipulated policy changes may have the very opposite effect in that they tend to take the pressure off, permitting the recipient to avoid having to make those very adjustments. This is the aforementioned extended version of the Dutch Disease. The donors achieve the desired commitment of resource flows and the recipient has the pressure for change relieved. Both parties can then claim that reform and disbursement targets have been more or less met; and, since there is no real evaluation of the effectiveness of the program, both parties can also declare the process a success and get ready for the next dance. But meanwhile the cost, while not transparent, has been severe, in terms of an increase in the size of available rents to be fought over, as well as the ever increasing levels of friction, fatigue and cynicism, accompanied, paradoxically, by what can be claimed as excessive interference in the internal affairs of the recipients.

The theory behind structural adjustment lending and its current incarnation in the form of PRSPs (Poverty Reduction Support Programs) is, of course, to permit the reform wing of a recipient government to convince its more recalcitrant wing that policy changes are necessary. But such arguments don't have a long half-life in the repeated game context I have suggested. It is always easy for the borrower to blame the lender, for excessive intervention, for bad policy advice, and subsequently, if necessary, for the failure of the program.

One additional problem, of course, has been that most donor agencies, to the extent that they are still permitted to focus on development as their primary objective, feel obligated to generate new ideas, some sort of "silver bullet," virtually every year as necessary for maintaining or increasing parliamentary allocations. This shift in emphasis confuses recipients and makes them even more suspicious concerning the asserted superior wisdom of the donors. Meanwhile, individual donor personnel recognition and promotions continue to be related to the fashioning of commitments; and bureaucracies are traditionally very good at linking every new idea to the continuation of customary country aid flows, with relatively small real changes at the margin. The lack of capillary action between the research or thinking and the operational or lending departments of most donors is very difficult to overcome as long as internal institutional cultures cannot be changed.

There has, of course, been some reaction to this growing consensus on the admitted failure of the Structural Adjustment era. We have seen an increasing emphasis on the need to move to more country "ownership," associated with a shift from structural adjustment to a greater focus on poverty under the HIPC/PRSP initiative, led by the Bank and the Fund, and supported by bilateral donors. However, the PRSP process, just like its structural adjustment predecessor, in fact still has the international donor community taking the initiative, convincing the recipient country of what it should ask for, what it must do in the way of a now admittedly somewhat more restricted series of policy changes, with the problem still the same, i.e. conditionality ex-ante, with ex-post the need to lend overcoming the need to ensure that real change does indeed occur. It is worth recalling that at a Kampala meeting in 2001, 39 organizations and regional networks in 15 African countries agreed that the PRSP's were simply window-dressing, i.e. structural adjustment loans wearing different clothing. We do know that both the IMF and the World Bank have issued large-sized, detailed manuals on how to prepare the PRSPs, hardly an indication of a real advance in true local "ownership." The fact that the technical assistance share of aid has doubled since the 60's certainly does not indicate much lessening of donor domination.

III: Possibilities for the Future

There are those, for example Abhijit Banerjee[8] and Bill Easterly[9], whose response to the demonstrated failure of the past has been to suggest that only a return to a piecemeal approach to aid can come to the rescue. They believe foreign aid can still do some good only if it is focused on well-defined small projects and avoids getting involved in macroeconomic policy discourse and conditionality. This reminds one very much of the hoary arguments of the past between project and program aid. Deworming drugs are seen as superior to health system reform and building schoolhouses superior to educational policy change. One hesitates to rise to that bait once again and remind the authors that one can build a perfect schoolhouse while educational policy is undermining what goes on inside – or that the current emphasis on good governance really calls for a change in macro institutional policy rather than a micro project approach. And have we forgotten about the fungibility of resources – especially given the increased technical competence of recipients? My bottom line: just because fast-disbursing policy-based program loans have not worked in the past, this should not lead one to the conclusion that the instrument itself is inherently deficient. Indeed, I remain convinced that it continues to represent potentially the best way of promoting development in the third world, and that a return to the "safe" ground of a projects-only approach emphasizing the

[8] "Making Aid Work," A. Banerjee and R.He, MIT, 2003.
[9] William Easterly, 2003, "Can Foreign Aid buy Growth," *Journal of Economic Perspectives* (27)3, p23-48

schoolhouses and infrastructure so beloved by some donors would be a large-size mistake.

But to make this potential real what is required is a rather substantial change in the basic modus operandi of aid giving, i.e. via the opening of new lending windows.[10] These new windows would permit donors, arrayed in the form of Consultative Groups or UNDP Round-tables to act more like banks, i.e. be in a position to sit back, encouraging would-be borrowers to approach only if and when they are ready with their own internally generated reform initiatives. In the absence of agreement on what constitutes an ideal generalizable development strategy – beyond macro-economic stability – traditional donor paternalism makes little sense. Indigenous technical as well as political consensus becomes essential. Such an approach would also ensure substantial country selectivity, safeguarding the critical initiative for recipient countries while passivity becomes the essential watchword for the donors.

Recipient countries not yet quite ready to prepare such a truly home-grown reform package could, of course, request technical assistance. But such help should come from third party, self-destructing teams, able to draw on the substantial expertise and experience of donor personnel, but cutting the link between advice and lending. The financing of such teams should come from foundations or possibly the UNDP.

In this fashion, the annual ritual dance that I have described above would be replaced by occasional serious bargaining, the setting of self-conditionality cum accompanying aid levels and an ultimate negotiated agreement on what needs to be done,

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[10] The basic proposal for such a change in the way foreign aid is transacted was first put forward by the author in 1985 (see "Debt, Adjustment and Development: The Lingering Crisis" in The Lingering Debt Crisis, Khadija Haq, editor. I have also very recently come across a May '99 paper by Ravi Kanbur , Todd Sandler and Kevin Morrison, "The Future of Development Assistance: Common Pools and International Public Goods," ODC Policy Essay No.25, which presents somewhat similar ideas.

all over a multi-year period. The system would, of course, also require a commitment by the donors to respond once proposals are submitted. Nor would they be expected to sign on the dotted line but to negotiate in good faith since both parties will have to vet the viability of any proposed reform cum aid package from both the economic and political points of view. In the donor countries, we are usually careful to distinguish between what the executive branch proposes and what parliaments decide, but we often don't offer the same understanding to recipients.

Opening such new multilateral windows would, of course, reduce the paternalistic and interventionist profile so often encountered in the aid giving process. It would also mean, however, that there has to be a restoration of credibility on another front, i.e. donors would have to commit to discontinue providing resources in the case of non-compliance with an agreed-on, if much shortened and more realistic, self-conditionality list. In other words, recipients would have to put themselves on notice that in order to ensure the continued flow of resources self-conditionality would have to be strictly adhered to, keeping in mind the inverse relationship between the number of such conditions and their implementability from the outset. The accompanying financial flows could then be used not only to buy off vested interest groups and ease the pain of adjustment but also to provide the required reassurance to the main stakeholders who are likely to gain in the longer run as a consequence of the reforms. Such a procedure would not only take account of the enhanced professional competence of recipient country policy makers but would also inject much needed credibility and freshness into a process which has become so fatigued and unproductive. For any given country there would inevitably be fallow years, possibly even extending into decades.

Realistically, “business as usual” country aid programming, if at somewhat lower levels, would have to continue, side-by-side with the opening of these new windows, for well understood political reasons. Individual donors will need to continue to do “their thing.” However, the main turn-around action would be elsewhere. While the new windows would always be open, i.e. when a proposal is generated by some country for a change in its policy rails, the donor community, represented by a Consultative Group or a Round Table of donors, would be expected to be in a position to respond with a ballooning of assistance. Such funding needs to be assured over 3-5 years, just as the impact of recipients’ policy change is a multi-year event.

Moreover, it is important that donors would stop disbursing if self-conditionality provisions are subsequently violated. The entire aid process would then no longer be subject to criticism from the left, claiming that aid is unduly neo-colonial by involving itself in the most sensitive domestic policy arenas; and the critics on the right worrying about “bottomless pits” would be disarmed if, in fact, the new system actually did yield real change. We know that development cannot as yet be entirely left to private markets in much of the third world and we clearly need to fix a system which is broken. To change the nature of the dance, the music has to change.

Admittedly, a major obstacle to this proposed new multilateral donor windows model is, of course, the previously referred to, stubbornly resistant, culture among donor personnel. As long as the signals governing evaluation and promotion continue to favor commitments rather than the harder to assess down the road qualitative results, the proposed shift will be difficult to accomplish. But the current high pitch discussion concerning the role of aid and globalization, as a possible problem as well as an opportunity, should help concentrate minds. Whether or not the rewards system among donors can be made consistent with the suggested emphasis on long-term quality as opposed to short-term quantity is still not clear and admittedly continues to represent a critical challenge. When queried on this point a couple of years ago, then World Bank President Wolfensohn's response that he had appointed a committee to look into it speaks volumes. Keeping donor personnel for longer periods in particular country-related positions would help.

An additional device to ensure that donor activity can be made consistent with the self-conditionality generated by recipients would be to take a leaf from the post-war Marshall Plan experience by installing peer reviews on a regional basis, with developing countries passing judgment on each other. The Marshall Plan had four elements making for success: one donor, high recipient country human capability, substantial country ownership of the reform program, and peer review. The one donor now needs to be replaced by a Consultative Group or Round-Table ; real country ownership can be achieved by abandoning the exclusive emphasis on "business as usual" country programming; and peer reviews can be tried on a regional basis, as is currently being attempted, with limited success to date, by the New Partnership for African Development (NEPAD). The increased passivity by donors required, accompanied by a major temporary ballooning of assistance, is admittedly a relatively tall order, amounting to a substantial shift in old habits. However, it would constitute a major turning point, not only in inducing substantive initiative among recipients but also in permitting donors to recapture real relevance.

Especially important in middle income countries, and even in the least developed, discussions about aid effectiveness should centrally include the facilitation of trade. For example, countries are often hesitant to liberalize their imports since the tariff revenue loss implied represents a serious deterrent and alternative taxes are usually difficult to come by. Aid can serve as a strictly temporary bridge until excise taxes, VAT, or some form of income taxation can be developed. In addition there is, of course, the more obvious use of aid for relevant infrastructure such as roads, ports and communication "to facilitate trade." But perhaps the real, and welcome, elephant in the room would be a contribution from aid funds to a global trade adjustment assistance program which plays by common, multilaterally agreed, rules and could make a major contribution to the liberalization of trade between North and South as well as within the South. As is well known, it is organized vested interests in the so-called "sunset industries" in donor countries which are often able to frustrate the possibility of positive sum games being played out via additional trade liberalization. What various countries at different stages of development have in common is the political inability to overcome the organized resistance of such interest groups. The provision of trade adjustment assistance, moving people, both entrepreneurs and workers, into "sunrise industries" would be a great help in overcoming this obstacle. Taking some foreign aid funds, and placing them in a multilateral set-aside under the auspices of the WTO, the World Bank or the UNDP would constitute a highly productive use of such resources.

It is well recognized that trade can do more for a developing country in the long run than aid. Even though East Asia is admittedly a very special case, we should nevertheless recall that aid there was relatively small in quantity but high in catalytic content, never amounting to more than 2% of GDP, and usually not for projects but in the form of program assistance focused on policy change. Quantitatively much larger aid allocations in South Asia, Sub-Saharan Africa and Central America did not yield anything similar in the way of success.

Both the narrow and extended versions of the Dutch Disease can be mitigated, if not entirely avoided. With respect to its narrow definition, to the extent recipients use aid to import investment goods, especially those directed to the facilitation of foreign trade, this can be all to the good. But even if the demand for non-tradeables rises as a result, if there is excess capacity in the country this does not necessarily lead to inflation and the feared harmful effects for the exchange rate and exports. There are, of course, other ways to avoid exchange rate appreciation, e.g. through sterilization of the inflows and/or reserve accumulation, both of which are, however, not easy to accomplish when domestic financial systems are still rudimentary, nor costless in terms of possible donor parliament negative reactions. But what is, to my mind, the more important, the extended version of the Dutch Disease, the impact of foreign aid flows on decision making, the only way to avoid that central problem is via a radical restructuring, i.e. a scaling up of aid without running into the deterioration of its quality by opening the new windows we have described.

IV. Conclusion

Development has gained new currency in recent years and foreign aid volumes are rising at the very time, paradoxically, that basic questions are being raised as to its effectiveness. Both the Structural Adjustment and PRSP processes have run their course, unable to alleviate the gloom. Monterrey and the Millennium Development Goals have helped raise aid levels but we have seen little effort to tackle aid effectiveness imaginatively. Given most of the evidence before us, tinkering at the edges won't do. Substantial changes are required if the malaise attending decades of ritual foreign aid dances is to be lifted. Opening new donor windows, accompanied by real donor passivity and real recipient ownership, plus the availability of aid ballooning when the time is ripe is suggested as the only dependable path to the enhancement of aid effectiveness.