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**Good Governance and the
Political Economy of Selectivity**

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INTRODUCTION

The attention of most Western policy-makers to the nature of political regimes in the developing countries is of relatively recent origin. For many policy-makers, the end of the Cold War was a watershed between negligence of and renewed attention for non-Western political systems. Part of the pre-Cold War lack of concern was attributable to the seemingly rigid power relations during the Cold War, while part of it was a function of political manipulation.

On the one hand, many Western politicians turned a blind eye to the political repression and violation of basic political rights and civil liberties in the countries that belonged to the Soviet Union's sphere of influence. For instance, 'dissident' movements, such as Czechoslovak *Charta 77* and Polish *Solidarnosć*, received attention from few Western politicians during the period of Soviet dominance of Central and Eastern Europe.

On the other hand, the attitude of many Western politicians toward developing countries was coloured by the position that these countries occupied in the bipolar world of the Cold War era. Statements such as 'He may be a son-of-a-bitch, but he's *our* son-of-a-bitch' and 'The enemy of our enemy is our friend', although both much older than the Cold War, can be cited as *credos* in the foreign policies of both superpowers and their allies. Concerns related to the maintenance of the two opposite Cold War alliances explain the long-term affiliation of the West to Mobutu's Zaire, and the superpowers' shift of allegiance between Menghistu's Ethiopia and Siad Barre's Somalia in 1977 without any concern for these countries' internal politics.

With the ending of the political dichotomy in world politics around 1990, the attention to the nature of the political regimes in developing countries has clearly gained momentum. Along with the emphasis on market-oriented policies, which had been the dominant trend in economic policies suggested to the developing countries after the Reagan-Thatcher 'revolution' of the early 1980s, the attention to the principles of governance of developing countries achieved prominence. 'Good governance', as it was called after the publication of a World Bank report on Africa (World Bank 1989) became an important objective in the policies of many aid-giving Western countries and the main international financial institutions, such as the World Bank.

This paper will try to analyse the confluence of good governance and market-oriented policies as they came to characterise and even dominate the foreign assistance agendas of some important bilateral and multilateral aid donors in the 1990s and the early twenty-first century. I will do this by analysing, in section 2, the roots of the good governance agenda in the analysis of institutions by so-called new institutional economists, such as Douglass North and Mancur Olson. In section 3, I will analyse the use of the good governance criterion in the discussions that were started, in the second half of the 1990s, about the effectiveness of development assistance. In section 4, several examples of the application of selectivity criteria to development assistance will be discussed, along with some empirical studies on aid selectivity and the criteria used in the selection process of some aid donors. In particular, I will focus on selectivity in the policies of the World Bank Group (in particular its International Development Association, IDA) the United States and the Netherlands. Section 5 will contain some concluding remarks.

INSTITUTIONS AND THE GOOD GOVERNANCE AGENDA

The good governance agenda of the 1990s and the early twenty-first century is inspired, to an important extent, by the mode of theorising that came to be labelled as the new institutional economics. The emphasis on good governance came after roughly a decade in which neo-liberal policies and market-oriented reform were the orthodoxy in development. This orthodoxy, which has often been referred to as the Washington consensus, advocated policies aimed at, among others, fiscal discipline, tax reform, financial liberalisation, trade liberalisation, privatisation and deregulation (Williamson 1997: 60-61). In the interpretation of several authors, the Washington consensus has given way to a ‘post-Washington consensus’, which implies an approach to development that ‘rejects the analytical agenda of state vs market and argues instead that the two must complement each other’ (Harriss 2002: 78).

Cammack (2002: 166) has analysed the recent emphasis on governance as an attempt to rescue the ‘doctrine for political development’ that lost its supremacy in development thinking with the demise of modernisation theory. In his view, the ‘new politics of development’ focuses on market-friendly government intervention, with the state’s role limited mainly to the definition and protection of property rights, the provision of effective legal, judicial and regulatory systems and an efficient civil service, and environmental protection.

The new institutional economics can be seen as a reaction to the dominant neo-classical analysis of the functioning of economies. As Douglass North (1990: 15) one of the founders of the new approach to economic theory, has emphasised following the work of Ronald Coase, the neo-classical equilibrium model assumes a frictionless world where economic transactions can be made without costs. In the context of the general equilibrium model, the analysis of individual behaviour is based on the assumption that individuals have perfect information about the transactions they wish to make and that the market is absolutely transparent. All information about transactions is assumed to be reducible to one figure: the market price.

According to the new institutional economics, on the contrary, transactions lead to costs that follow from the procurement and processing of information. These costs cannot be deduced directly from the price of goods and services. This view leads to an interest in institutions: 'when it is costly to transact, institutions matter' (North 1990: 12).

Nabli and Nugent (1989: 1336-1337) have pointed out several important recurring themes in the literature on transaction and information costs. Firstly, they emphasise the idea that institutions reduce transaction costs by internalising transactions. Certain transactions take place within organisations, rather than in the market, because certain costs (such as surveillance and quality control) can be avoided in that way.

Secondly, the literature on transaction costs has paid much attention to the creation and functions of property rights. Property rights are seen as instruments for the internalisation of external effects. It is argued that property rights help to increase economic efficiency and lead to economic progress, because the certainty and trust needed for making transactions is enhanced. Since the delimitation and enforcement of property rights is considered to be relatively costly, it is assumed that property rights are generally established when certain resources are becoming scarce, for instance as a result of population growth or technological change (cf. Clague 1997: 19-20).

Thirdly, the transaction cost literature focuses on incomplete and asymmetrical information. The moral hazard problem, which relates to the separation of individual and collective logics, is a case in point. Moral hazard exists in situations where individuals or groups are engaging in relatively risky behaviour because they know that the costs involved in that behaviour are partly or wholly borne by others.

Related to this idea is the theory of collective action, which occupies an important place in the new institutional economics (cf. Olson 1997). Following Olson, many theorists have argued that the production of public or collective goods is problematic in those cases where individuals, who are benefiting from the public good, do not feel compelled to contribute to the costs of the good (Clague 1997: 21). Particularly in circumstances where individuals can hide as free riders within a large group, 'underproduction' of the public good is a real danger. Institutions are seen as instruments that can monitor individuals' behaviour and convince or force them to take their share of the costs involved.

Lin and Nugent (1995: 2342-2353) have analysed the contribution of the new institutional economics to development theory. They emphasise the role of households in the development process *vis-à-vis* tribes and clans. According to these authors, households tend to occupy a more important position in the socioeconomic order as soon as the scarcity of land and other natural resources is increasing and collective property is considered less productive. Transaction costs can be seen to fall because the 'self-supervision' of production takes the place of collective, hence less direct, control of the production process at the tribe or clan level.

With the increasing importance of technology in production, and the growing importance of capital, the household level is argued to lose much of its efficiency. The development of markets and institutions for credit and payments is taken to be a necessary condition to achieve higher degrees of specialisation and a more complex division of labour. This change is assumed to produce a change in contractual forms: rent and share contracts will give way to fixed wage contracts, which will gradually become the dominant form.

Lin and Nugent argue, further, that traditional norms, which were crucial to the proper functioning of informal institutions, lose part of their importance as the development process gets under way, and that traditional ways of sanctioning deviant behaviour become gradually less effective. The state takes the place of traditional institutions and steadily assumes responsibilities in regulation, tax collection and the production of collective goods. Expansion of the geographic scope of exchange is expected to lead to the expansion of market externalities (such as technology and information, which both have important characteristics of public goods). The state is in a better position than other institutions to internalise such externalities and provide public goods. By virtue of its exclusive competencies in the use of

force and the collection of taxes, the state has more opportunities to unilaterally decide on the production of collective goods than any other institution.

Douglass North (1987: 422-425) has made a connection between the development of specific institutions and economic progress. On the basis of four variables that influence the costs of economic transactions – the costs of measuring, the size of the market, the possibility of enforcement, and ideological attitudes – North has developed three ideal types of economic organisation. In situations of personal exchange, where business is based on small-scale production and local trade, transaction costs tend to be low. The costs of production in this type of economic organisation tend to be high, because specialisation and division of labour play only a marginal role. The second ideal type, impersonal exchange without third party enforcement, can be found in trading at traditional bazaars and production through serfdom and slavery. In such circumstances, transaction costs tend to be high and the advantages deriving from trade are limited. Only the third form of organisation, impersonal exchange with third party enforcement, is conducive to sustained economic growth, according to North. In such a situation, significant benefits will result from economic specialisation. Because of the existence of a third party that is capable of enforcing obligations, economic agents can enter into long-term transactions – such as investment – without needing to worry about the security of their possessions.

North has cautioned against too much optimism about institutions and against teleological arguments about economic progress. Institutions, he argues, are not neutral actors: ‘Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules’ (North 1995: 20). Even in those cases where the creation of certain institutions would contribute to general social welfare, the coming into being of institutions is not inevitable. The economic success of the West is, thus, the exception rather than the rule: ‘economic history bears abundant testimony to economic growth being the exception’ (North 1995: 21). Institutions, in North’s conception, are highly *path dependent*, which implies that existing institutional frameworks are resistant to change, because of the entrenched interests of certain social and economic groups. This means that countries that have a history of less efficient institutional structures cannot hope for sudden improvements in their institutional makeup.

North has argued that it is difficult to derive recommendations for developing and transition countries from the new institutional economics. Despite his caution, North has claimed that ‘adaptive efficiency’ is a more relevant objective for developing economies than ‘allocative efficiency’. Institutions need to adjust to changing circumstances and need to contribute to efficient economic processes under new conditions. This requirement has a significance that is broader than just the allocation of the means of production: ‘Allocative efficiency is a static concept with a given set of institutions; the key to continuing good economic performance is a flexible institutional matrix that will adjust in the context of evolving technological and demographic changes as well as shocks to the system’ (North 1995: 26).

In addition to the foregoing, North has argued that political institutions can only be stable when they are supported by social organisations that have an interest in their continued existence; an essential element of political-economic transformation is the creation of such social organisations. The lesson that can be learnt from Western history, according to North, concerns the centrality of the rule of law and the safeguarding of civil liberties and political rights: ‘While economic growth can occur in the short run with autocratic regimes, long-run economic growth entails the development of the rule of law and the protection of civil and political freedoms’ (1995: 25).

In conclusion of this section, it may be argued that the new institutional economics has added nuances to the neo-classical, equilibrium-oriented understanding of markets, but that markets have nevertheless remained central elements in the explanation of development and growth. As was shown above, the argument of new institutional economists such as Douglass North still hinges on the development of an efficient allocative mechanism and a productive division of labour. The new institutionalist economists assume, however, that markets will not develop spontaneously and that institutional mechanisms are necessary for the good functioning of markets. The state as an enforcement mechanism of property rights and contractual obligations is instrumental to all this.

The good governance agenda that is the result of this thinking focuses on the market. It is market processes that are assumed to generate wealth, and as such there is no alternative development mechanism to the market. Good and efficient markets, according to this theoretical perspective, can develop and function only in the context of institutions that allow

the market to work. A system of property rights, the rule of law and contract enforcement are all seen as market-related institutional prerequisites for development.

GOOD GOVERNANCE, DEVELOPMENT ASSISTANCE AND SELECTIVITY

The end of the twentieth century saw an important change in the discourse on development assistance. The instrumentality of aid – according to which aid was either a means to fill up a capital gap or a mechanism for the redistribution of wealth – was increasingly questioned. Part of the explanation for this can be found, according to Thorbecke (2000: 44) in the growing scepticism about aid conditionality. A first element fuelling the scepticism was the apparent inability of donor governments to ‘buy’ policy change, because of the fungibility of aid. A second factor behind the scepticism, mentioned by Doornbos (2001: 102-103) was the unfeasibility of monitoring the implementation of such conditionalities in a great number of countries and sectors.

The discussion about the effectiveness of conditionalities fed into a wider debate about the effectiveness of development assistance generally (Thorbecke 2000: 45). This debate derived from the awareness that decades of development assistance had not led to the eradication of poverty (e.g. Easterly 2002: 47). In fact, there are indications that the number of people who are living in extreme poverty – i.e., at less than \$1 a day – has increased since the late 1980s (Wade 2001).

Two World Bank reports, which both focused on the effectiveness of development assistance (Burnside and Dollar 1997; World Bank 1998) gave new impetus to the discussion about aid effectiveness, and made a connection between aid and good governance. In these two reports, it was argued that development assistance is effective only in aid-receiving developing countries that possess good institutions and/or implement good policies. Both features were taken as signs of the existence of good governance in developing countries.

The focus on governance issues during the last two decades has shown that there are at least two quite different interpretations of the role of governance in development, which relate to distinct understandings of the *meaning of the concept* of (good) governance. In an article on governance, the state and the politics of development, Adrian Leftwich (1994: 365-6) distinguished between two meanings: (a) a ‘more limited meaning ... associated with the World Bank which interprets [governance] in primarily administrative and managerial terms’,

and (b) a ‘meaning, associated with western governments, [which] is more political’ and ‘includes an insistence on competitive democratic politics as well’.

The first meaning of (good) governance, which could be seen as the *technocratic* interpretation (the term is used by Van Cranenburgh 1998: 77 and Hoebink 2001: 188) focuses on the way in which the public sector is managed. Leftwich (1994: 372) has identified the following four main areas of concern in technocratic governance:

- accountability, which involves holding government officials responsible for their actions;
- legality, which means that there is a structure of rules and laws that provides predictability for the public sector;
- the availability of information about economic conditions and government policies;
- transparency, which refers to the existence of an ‘open government’, whose decision making procedures are clear to everybody who wishes to know about them.

The second, *political*, interpretation of (good) governance focuses on the way in which the political and legal system of developing countries is organised (Hoebink 2001: 188). In the first place, this approach seems to stress the existence of a well-functioning legal system, which protects the rights and freedoms of citizens. Adherence to and implementation of internationally agreed human rights conventions are crucial in this interpretation. Next to this, the presence of democratic rules and procedures is emphasised. In particular, multiparty democracy, the existence of a pluralist press, and the functioning of an active civil society appear to be elements that are crucial to this interpretation of governance.

The two World Bank studies that were referred to above have changed the aid agenda of the late-1990s. The conclusion that was drawn on the basis of Burnside and Dollar (1997) and World Bank (1998) was that it simply does not pay off to give aid to countries with bad governance. As the latter report puts it:

The development strategy emerging from this view is two-pronged – put in place growth-enhancing, market-oriented policies (stable macro-economic environment, effective law and order, trade liberalization, and so on) and ensure the provision of important public services that cannot be well and equitably supplied by private markets (infrastructure services and education, for instance). Developing countries with sound policies and high-quality public institutions have grown much faster than those without – 2.7 percent compared with -0.5 percent per capita. Put simply, failures in policymaking, institution building, and the provision of public services have been more severe constraints on development than capital markets. ... The key recommendation from these findings is not that finance should go only to

well-managed countries. Rather, we recommend that aid be allocated on the basis of poverty and economic management. Among countries with similar poverty levels but different policy regimes, more finance should go to the countries with better management (World Bank 1998: 11, 15-16).

The Assessing Aid report, from which this quotation was taken, thus explicitly laid the foundations for a move toward selectivity in development assistance (cf. Hermes and Lensink 2001:8-9).

Both Burnside and Dollar (1997) and World Bank (1998) made their assessment of the effectiveness of aid on the basis of an index that was used as the operationalisation of the quality of governance. Burnside and Dollar (1997: 19-20) constructed a ‘policy index’, using budget surplus, inflation level and trade openness as indicators. These World Bank staff members found that the level of aid received, when interacted with the policy index, has a positive impact on economic growth in a sample of 56 countries for which data on six four-year periods from 1970 through 1993 were available. World Bank (1998: 122-124) constructed an ‘index of economic management’, which was computed as a weighted sum of the inflation rate, budget surplus, trade openness and a measure of institutional quality, which was calculated with indicators on the bureaucracy, corruption, the rule of law, the risk of expropriation, nationalisation and contract repudiation. The World Bank report found, similar to Burnside and Dollar’s study, that aid has a positive effect on economic growth when it is given in the context of good economic management.¹

The discussion in this section has shown that the good governance agenda that had been developed since the early 1990s got a new impetus with the attention to the effectiveness of conditionalities and of development assistance, more generally. The late 1990s witnessed a ‘paradigm shift’ with the supposed backing of the move towards greater selectiveness in assistance relations by empirical research undertaken by World Bank staff members. In the approach developed and propagated by David Dollar and his team of researchers the concern for good governance, understood in terms of the quality of institutions, was married with an emphasis on good policies. Good policies in the World Bank context were defined in terms of the qualities that, earlier, were dominant elements of the market-oriented Washington consensus, such as trade openness and fiscal and monetary discipline.

GOOD GOVERNANCE AND AID: CASE STUDIES

The International Development Association (IDA) and Performance-Based Allocation

The credo of the International Development Association (IDA) which is often described as the World Bank’s ‘soft-lending window’ for the world’s least developed countries, is summed up at the IDA website:

Research shows that aid is most effective in spurring growth and poverty reduction in countries that have a strong commitment to reforms. IDA leads all development institutions in directing its assistance to countries that pursue poverty-reducing policies. IDA employs a performance-based allocation system to channel its resources to countries that are undertaking reforms. Through targeted allocations, effective leveraging of resources, and country-based strategies, IDA is helping the poorest countries participate in the world economy, and promoting equity and inclusive growth for their poorest citizens (International Development Association 2003c).

Starting in 1977, the IDA has based its allocation of funds on a so-called performance-based allocation system. Performance has gradually become understood as ‘a borrower’s implementation of sound policies and institutional arrangements conducive to sustainable economic growth and poverty reduction within a framework of good governance, as well as effective implementation of its portfolio of ongoing IDA operations’ (Operations Evaluation Department 2001: iv). The main instruments in the performance-based allocation mechanism used by IDA are the Country Policy and Institutional Assessment (CPIA) index and the related ‘governance factor’.³

All IDA-eligible borrowers (currently 81)⁴ receive an initial performance rating on the CPIA index. The scores on the CPIA index are a composite of scores on 20 items (each ranging from 1–6) in four categories, given by a country team of World Bank staff under the guidance of the central CPIA manager (Operations Evaluation Department 2001: 14) on the basis of an assessment questionnaire (International Development Association 2002a). The 20 items are given in table 1 below.

Table 1: Country Policy and Institutional Assessment Criteria 2002

<i>I.</i>	<i>Economic management</i>
1.	Management of inflation and macroeconomic imbalances
2.	Fiscal policy
3.	Management of public debt (external and domestic)
4.	Management and sustainability of the development programme
<i>II.</i>	<i>Structural Policies</i>
5.	Trade policy and foreign exchange regime
6.	Financial stability
7.	Financial sector depth, efficiency and resource mobilisation
8.	Competitive environment for the private sector
9.	Factor and product markets
10.	Policies and institutions for environmental sustainability
<i>III.</i>	<i>Policies for social inclusion/equity</i>
11.	Gender
12.	Equity of public resource use

13. Building human resources
 14. Social protection and labour
 15. Monitoring and analysis of poverty outcomes and impacts
- IV. Public sector management and institutions*
16. Property rights and rule-based governance
 17. Quality of budgetary and financial management
 18. Efficiency of revenue mobilisation
 19. Quality of public administration
 20. Transparency, accountability and corruption in the public sector

Source: International Development Association 2002a: 1.

Among the 20 items are six criteria that the IDA considers to be particularly relevant for judging governance; these are items 4 and 16–20 in table 1 (International Development Association 2002b: 4). The choice of criteria reflects the predominantly technocratic approach to governance in World Bank circles (see p. 8 above). Apart from being part of the CPIA and the ensuing rating of countries, the governance items are singled out and combined in a ‘governance factor’. The governance factor is calculated on the basis of the following formula, where an average score of 3.5 on the six governance criteria is seen as the cut-off between an unsatisfactory and a satisfactory governance rating:

$$\text{governance factor} = (\text{average rating on governance items}/3.5)^{1.5}$$

The governance factor is multiplied with the initial country performance rating, so that a country that scores above 3.5 on the governance criteria will receive a premium and a country that scores below 3.5 will receive a discount (International Development Association 2002b: 4). The potential impact of governance assessment is gauged as ‘severe’ by the World Bank’s Operations Evaluation Department, as they calculate that the effect of a score of less than 2.0 on three governance criteria ‘reduces the overall performance rating by one-third, causing the IDA normative allocation to be cut by about half’ (Operations Evaluation Department 2001: 31).

The IDA allocation for 2004-2006 that has resulted from the performance evaluation is given in table 2.

Table 2: IDA Allocation, 2004-2006 by IDA Performance Quintile

Performance quintile	Number of countries	Population weighted	
		Average rating	Average allocation (in US\$ per capita per year)
First	13	4.17	12.0

Second	12	3.43	8.8
Third	13	2.99	5.8
Fourth	13	2.53	5.4
Fifth	12	1.60	2.4
Total	63	2.82	6.2
Ratio first/ fifth quintile			5.0

Source: International Development Association 2003a: 8.

Table 2 makes clear that there is quite a range of allocated funds to countries in the different quintiles. The ratio of the first (i.e., best performing) quintile to the fifth is calculated as 5.0, and thereby is almost twice as high as the corresponding ratio of actual lending in the 2000-2002 period. This effect is due, according to IDA, to ‘the introduction of the governance factor with its broad impact across the rating spectrum’ (International Development Association 2003a: 9).⁵

The United States and the Millennium Challenge Account

With around \$10 billion allocated to official development assistance (ODA) annually, the United States was the world’s second largest bilateral donor in 2000. As ODA was only 0.10 per cent of the U.S. gross national product, the United States, at the same time, was in relative terms the smallest bilateral donor (U.S. Agency for International Development 2002: 134). In March 2002, President Bush announced the so-called Millennium Challenge Account that would increase the U.S. budget for development assistance by \$5 billion a year, bringing ODA to roughly \$15 billion. In his speech to the Inter-American Development Bank, Bush called the Millennium Challenge Account ‘a “new compact for development” that increases accountability for rich and poor nations alike, linking greater contributions by developed nations to greater responsibility by developing nations’ (U.S. Government 2002).

The Millennium Challenge Account needs to be understood against the background of the U.S. motivation to provide foreign assistance, which, according to USAID, is connected closely with its definition of the national interest. A recent USAID report argues that fostering development abroad serves the U.S. security interests, because this pre-empts threats and disasters, opens new markets for U.S. goods and services, leads to secure environments for U.S. investment, creates order and peace so that Americans can travel, study and do business, and produces allies (U.S. Agency for International Development 2002: 2).

According to USAID, the basis for giving U.S. development assistance should shift ‘from conditionality to selectivity’ and, thus, reward countries with good policies and institutions: ‘A better approach is to dispense aid selectively to reward and deepen – and thus preserve and consolidate – reforms that a country has already begun to implement according to its own design’ (U.S. Agency for International Development 2002: 49). Good governance is perceived, by USAID, to be a *conditio sine qua non* for development assistance, as ‘[n]o amount of resources transferred or infrastructure built can compensate for – or survive – bad governance’ (U.S. Agency for International Development 2002: 6). At the same time, it is clear that good governance is not defined as something that is relevant to the public sector only. USAID explicitly links the nature of the political system to the functioning of the private sector and stresses the centrality of the protection of property rights:

the prospects for development, and for effective development assistance, depend on the quality of governance – the way in which public power is exercised and public resources are managed and expended. Poorly performing states – those mired in poverty and illiteracy for decades – will not achieve sustainable development unless they dramatically improve governance. Only when the rule of law ensures property rights and low transaction costs will domestic capital be invested productively and international capital flow in. But corruption and weak rule of law will persist until voters have the power to remove governments that fail to perform – politically as well as economically (U.S. Agency for International Development 2002: 42, italics added).

‘Sound economic policies’, which relate, in USAID’s view, to good governance, have to do with the functioning of national markets, as well as with the integration of developing countries in the world economy through trade and investment (U.S. Agency for International Development 2002: 56-64). Referring to the captions of two figures presented by USAID, ‘greater freedom means greater integration with global markets’ and ‘market integrators grow faster’ (U.S. Agency for International Development 2002: 60-61, figures 2.2 and 2.4).

The Millennium Challenge Account is based on the principle of aid selectivity, as it intends to support countries that are good performers in terms of ‘governing justly, investing in people, and encouraging economic freedom’ (White House Fact Sheet, 25 November 2002, in U.S. Department of State 2003: 32). In order to select developing countries that perform well on the three criteria, a new government corporation, referred to as the MCA Corporation (U.S. Government Background Paper, 5 February 2003, in U.S. Department of State 2003: 29)

will rate developing countries on 16 indicators. The indicators, categories and sources of data are summed up in table 3 below.

Table 3: Selection Criteria in the Millennium Challenge Account

I. Governing justly

1. Civil liberties (Freedom House)
2. Political rights (Freedom House)
3. Voice and accountability (World Bank Institute)
4. Government effectiveness (World Bank Institute)
5. Rule of law (World Bank Institute)
6. Control of corruption (World Bank Institute)

II. Investing in people

1. Public primary education spending relative to GDP (World Bank/ national sources)
2. Primary education completion rate (World Bank/national sources)
3. Public expenditures on health relative to GDP (World Bank/national sources)
4. Immunisation rates: DPT and measles (World Bank/United Nations/national sources)

III. Promoting economic freedom

1. Country credit rating (Institutional Investor Magazine)
 2. Inflation (IMF)
 3. Three-year budget deficit (IMF/national sources)
 4. Trade policy (Heritage Foundation)
 5. Regulatory quality (World Bank Institute)
 6. Days to start a business (World Bank)
-

Source: White House Fact Sheet, 25 November 2002 in U.S. Department of State 2003: 32

Under the Millennium Challenge Account, developing countries will qualify for support if their per capita income is below a certain minimum and if they do well in all three categories mentioned in table 3. Performance is measured as scoring above the median on at least half of the indicators in all three categories. In addition to this, countries are required to score above the median on the corruption indicator (number 6 in category I) in order to be selected. During the first years of the Millennium Challenge Account, only countries with an income below the historical IDA cutoff level of \$1,435 per capita will be eligible for funding; in addition, in 2004, this group will be limited to the developing countries that are eligible to borrow from the IDA. As of 2006, all countries with incomes up to the lower middle income level (\$2,975 per capita) will also qualify for competition for Millennium Challenge Account funds. Separate competitions are envisaged for the countries with an income below the IDA cutoff level and the countries with a higher income. (White House Fact Sheet, 25 November 2002, in U.S. Department of State 2003: 31-32). The final list of countries that would be recommended to the U.S. President for inclusion in the Millennium Challenge Account would

be based on the above-mentioned criteria, plus additional considerations related to ‘data gaps, lags, trends, or other material information, including leadership, related to economic growth and poverty reduction’ (White House Fact Sheet, 25 November 2002, in U.S. Department of State 2003: 32).

In a recent article, Radelet (2003) has analysed which countries would qualify for funding under the Millennium Challenge Account given its criteria of good governance, social policies and economic freedom. These countries are presented in table 4 below.

Table 4: Qualifying Countries for the Millennium Challenge Account

<p>Year 1: IDA-eligible countries with incomes below \$1,435 per capita <i>Qualifying countries:</i> Albania, Bangladesh, Benin, Bolivia, The Gambia, Georgia, Honduras, Lesotho, Malawi, Mongolia, Nepal, Senegal, Sri Lanka <i>Eliminated by corruption:</i> Moldova, Nicaragua <i>Missed by one indicator:</i> Cambodia, Côte d’Ivoire, Ghana, Guyana, India, Mali, Mozambique, Vietnam</p>
<p>Year 2: All countries with incomes below \$1,435 per capita <i>Qualifying countries:</i> Benin, Bolivia, China, Honduras, Lesotho, Malawi, Mongolia, Philippines, Senegal, Sri Lanka, Vietnam <i>Eliminated by corruption:</i> Ecuador, Moldova, Nicaragua, Ukraine <i>Missed by one indicator:</i> Albania, Bangladesh, Cambodia, Côte d’Ivoire, The Gambia, Georgia, Ghana, Guyana, India, Mali, Morocco</p>
<p>Year 3: Additional category of countries with incomes between \$1,435 and \$2,975 per capita <i>Qualifying countries:</i> Bulgaria, Egypt, Namibia, Peru, South Africa <i>Eliminated by corruption:</i> none <i>Missed by one indicator:</i> Jamaica, Jordan, Tunisia</p>

Source: Radelet 2003: 177

The Netherlands and the Selection of 17 Structural Partner Countries

After decades of zealous commitment to development assistance on a project basis, which led to an involvement with almost 120 developing countries, the Netherlands’ government in 1998 decided to reduce the number of aid-receiving countries. The primary criteria for the revamping of Dutch development assistance would be the average level of income and the quality of governance in potential recipient countries (Minister for Development Cooperation 1998: 3). The selection process resulted in an initial choice for 19 structural and three temporary partner countries (Minister for Development Cooperation 1999a: 5).

The formation of the second government that was headed by labour party leader Wim Kok was concluded, in August 1998, with two major changes in the domain of development policy. The first change was the replacement of Jan Pronk, who had been minister for development cooperation from 1973 to 1977 and from 1989 to 1998, by Eveline Herfkens, a former World Bank director. The second change concerned the policy orientation of the

Netherlands on development cooperation. The second so-called ‘purple’ coalition of the labour party (PvdA) the right-wing liberals (VVD) and the social liberals (D66) agreed to concentrate the allocation of structural Dutch development assistance on countries that would meet the criteria of ‘good policy, including economic policy, and good governance, on the basis of international standards’ (Regeerakkoord 1998: 93).²

The change of development policy in the second Kok government reflected the increasing dominance of the aid debate by the multilateral financial agencies, most notably the World Bank. As alluded to in Hoebink’s (2001: 178-9, 188) recent overview of the use of criteria in European development assistance, the Dutch position on good governance bears considerable resemblance to the ‘technocratic’ approach to the issue, which focuses on the functioning of state institutions and the implementation of policies aimed at monetary and fiscal discipline and openness to trade. In comparison with the policies of other European governments, recent Dutch development cooperation is much less influenced by other interpretations of the good governance concept, which focus on the promotion of human rights (as in the case of the Scandinavian countries) or see good governance primarily as a means for reducing poverty (as in the British position on development cooperation).

Towards the end of 1998, Minister Herfkens sent a letter to Parliament which contained the outline of the policy that has been implemented in subsequent years. According to her letter (Minister for Development Cooperation 1998: 3) the restructuring of structural development assistance (the part of official development aid that is channelled through Dutch embassies in developing countries) would mean a reduction of the group of 78 major recipient countries (the countries that received more than 1 million guilders in 1997). The primary criteria for the reduction of the number would be the recipients’ socioeconomic policy and the ‘situation in the realm of good governance’. In addition, the extent of poverty and the need for aid, operationalised as a maximum per capita GNP of \$925, would be applied as a third principle: ‘An important part of the existing international consensus is that the limited availability of concessionary funds requires the concentration of aid on poorer countries.’

According to Herfkens’ letter to Parliament of November 1998, the Dutch government would base its judgement of developing countries’ socioeconomic and macroeconomic policies on the reporting of ‘relevant multilateral organisations’. Its judgement of the quality of governance would involve the assessment of the countries’ financial management, the state of human rights protection and the level of democratisation of society (Minister for

Development Cooperation 1998: 3-4). From a later communication of the Minister to Parliament one may conclude that the prime instrument for judging the quality of governance and policy appears to be the CPIA index that was discussed in section 4.1 (Minister for Development Cooperation 1999b: 2-3).

The initial selection of countries that resulted from the application of these criteria was subject to 'a series of additional considerations', such as the quality of the existing development assistance programme in the recipient country, the efforts of the potential recipient to strengthen the regional legal order, the relative importance of Dutch aid in the light of the presence of other bi- and multilateral donors, and the recipient country's socioeconomic or cultural relations with the Netherlands. Finally, the Minister indicated that attracting investment from the Dutch private sector in 'growth industries' would be an important task for the embassies in their implementation of the development assistance policy (Minister for Development Cooperation 1998: 4-5).

The original selection of countries was put before Parliament in February 1999 and included a list of 19 plus three potential recipients: Bangladesh, Bolivia, Burkina Faso, Eritrea, Ethiopia, Ghana, India, Macedonia, Mali, Mozambique, Nicaragua, Pakistan, Sri Lanka, Tanzania, Uganda, Vietnam, Yemen, Zambia, Zimbabwe, South Africa, Egypt and the Palestinian Territories (Westbank and Gaza). Pakistan and Zimbabwe were subsequently removed from the list because of the internal political situation. South Africa, Egypt and the Palestinian Territories were included for a variety of (mainly political) reasons, such as the transition to a new political regime, the elimination of pockets of poverty and support for the Middle East peace process. It was envisaged that these countries would receive Dutch development assistance for a limited period of time, with a maximum of five years (Minister for Development Cooperation 1999a: 5). The Palestinian Territories were later removed from the list of temporary partner countries, while Indonesia was added.

In addition to the 17+3 countries that were judged as eligible for structural assistance, a total of 28 countries have been selected for support of environmental policies or for human rights, peace-building and good governance programmes. The relative importance of structural development cooperation vis-à-vis the thematically oriented programmes is underlined by the amount of money that is allocated to these two parts of the Dutch development assistance budget: in the budget for 2000, 959.4 million guilders were earmarked for the 17+3 countries, while 475.6 million guilders were assigned for spending in

the 28 'theme countries'. The remaining 24 countries, which were not included in any of the abovementioned categories, are considered as 'exit countries', 'where it is, on the whole, possible to end existing projects and programmes within a period of two to three years without capital destruction' (Minister for Development Cooperation 1999c: 6).

Empirical Analyses of Aid Selectivity

Given the limited time that has passed since the introduction of governance-based selectivity into development assistance policies, it is not very surprising that there are few empirical studies of the implementation of the selectivity principle. There are some studies, however, that provide some insight into the problems connected with selectivity.

Focusing on the International Development Association and its performance-based allocation mechanism, Easterly has criticised the pretension that the World Bank and its soft-lending window have been able to make an effective link between the quality of governance and aid provision. On the basis of yearly correlations (related to the 1977-1999 period) between the quality of governance, as measured by the CPIA index, and the granting of World Bank adjustment loans, on the one hand, and IDA lending, on the other, Easterly (2002: 37-38) concludes that '[t]here is no evidence of a significant positive association between good policies ... and aid flows in the 1990s or at any other time' and that the 'association [between policy rating and IDA loans] is not robust across years or across definitions of the IDA flow'.

In an analysis of IDA lending in the 2000-2002 period, Koch (2002: 5-6) focused on the impact of changes in policy rating – as expressed in the CPIA index – on IDA allocations. Koch arrives at a conclusion that is different from Easterly's: in the period under investigation, a change in policy rating appeared to have a significant influence on the change of IDA allocation. This conclusion may result, in part, from the fact that Koch has studied a different period than Easterly and from the changes that the IDA had introduced into the performance-based allocation methodology (in particular, the increased importance of governance-related indicators). In any case, Koch (2002: 4) arrives at the conclusion that it is 'highly debatable' whether the indicators included in the CPIA index 'always support growth and poverty reduction'. Rather, he suggests that '[t]he good governance agenda is partly used to further parts of the traditional Washington Consensus'.

A study of the selection process of structural aid-receiving countries undertaken by the government of the Netherlands in 1999, brings Hout to the conclusion that the outcome of the selection can be understood mainly as a choice for countries with market-friendly policies. In a research design based on logistic regression analysis, Hout (2002: 521-522) finds that only average income level and 'regulatory burden' ('the incidence of market-unfriendly policies such as price controls or inadequate bank supervision, and the burdens imposed by excessive regulation in areas such as foreign trade and business development') are significant predictors of the inclusion or exclusion of aid recipients. In his conclusion, Hout (2002: 524) points at the bias of Dutch development assistance policies towards the Washington consensus and agrees with Pronk (2001) that 'heterodox' policies, such as those aimed at reducing inequality, supporting agriculture or social policy, are rewarded much less by this selectivity approach.

Koch has also analysed the selectivity of Dutch development assistance. In an initial analysis, his findings support Hout's, in that the importance of market-friendly policies, along with the CPIA rating (which, in itself, is biased towards market oriented policies and institutions) is found to determine the choice for partner countries (Koch 2002: 9). A further analysis finds, however, that *changes* in aid allocations cannot be explained by these same variables; the inherent rigidity of the allocation of assistance appears to be a better explanatory variable (Koch 2002: 10-11, 2003: 72-73).

Conclusion

This section has analysed the move towards selectivity of three donors in the contemporary development assistance community. It is evident from the description in sections 4.1, 4.2 and 4.3 that similar considerations about good governance inspired the IDA to include the governance discount and governance factor, the United States to initiate the Millennium Challenge Account, and the Netherlands to adopt a more restrictive policy *vis-à-vis* the support of structural development partners. In all cases, the assumption was that good governance – implying the existence of certain institutions and the implementation of certain policies – is a necessary condition for the success of development assistance policies. An implicit assumption seems to be that the targeting of development assistance to 'good performers' will stimulate other developing countries to improve their governance, and thereby qualify for development assistance.

Both the analyses of the policies of IDA, the United States and the Netherlands and the empirical analyses of aid selectivity, discussed in section 4.4, brought out that the good

governance concept is not confined to institutions or principles of governance, but more often than not includes a clear preference for certain policies. This preference is probably clearest in the use of criteria applied by IDA in its Country Policy and Institutional Assessment (CPIA) process, which shows a clear bias towards policies that are favoured as part of the Washington Consensus. The results reported by Koch (2002) support this judgement.

At first glance, policies seem to be less important in the U.S.' Millennium Challenge Account. The prominence of policies becomes immediately clear, however, when the programme's methodology is taken into consideration: in order to qualify for support under the Millennium Challenge Account developing countries will need to score above the median in all three categories of selection criteria; thus, the implementation of preferred policies is a *conditio sine qua non* for inclusion in the programme.

In the case of the Netherlands' move towards selectivity in development assistance, the rhetoric that was used to accompany the reorientation of policy clearly shows the influence of World Bank thinking. The emphasis on good policies, and the embracing of the CPIA index for judging recipient governments' performance, brings out the 'technocratic' focus of Dutch development policy after 1998. This judgement is reinforced by research findings reported in Hout (2002) who found that, along with a poverty variable, pro-market policies are the prime explanatory factor for the Dutch choice of partner countries.

CONCLUSION

In this paper, I have analysed the concern with the political system of developing countries after the end of the Cold War. This concern came after decades of relative negligence of the internal politics of these countries. Although spurred by the end of the Cold War, the good governance agenda of the post-1990 period was fed by a change of academic focus – most evident in the rise of the new institutional economics – towards institutions and their role in the development process. The main tenets of the new institutional economics are that the proper functioning of markets, as allocative mechanisms, is a necessary condition for development, and that markets will not come into being spontaneously, but are partially the result of a good institutional environment.

The discourse on development assistance at the end of the twentieth century saw a change toward selectivity. This change resulted from a reappraisal of conditionalities as policy tools, and of the effectiveness of development assistance more generally. Two reports

produced by the World Bank – Burnside and Dollar (1997) and World Bank (1998) – were instrumental in providing the argument that aid would make a difference for development only in situations of good governance and good policies. Good policies were understood primarily in terms of trade openness and fiscal and monetary discipline.

The selectivity principle was adopted by several aid donors in the late 1990s and the early twenty-first century. The World Bank's International Development Association introduced the so-called governance discount and governance factor in its performance-based allocation mechanism. In the United States' Millennium Challenge Account, announced in early 2002, good governance features as a prerequisite for developing countries' qualification. Finally, the Netherlands has applied criteria of good governance and good policies in its selection of a limited number of countries that qualify for a structural development assistance relationship. The description of the policies of these three donors, as well as some empirical analyses, makes clear that certain policies – in particular, pro-market policies – rank prominently among the requirements that are set for development assistance.

The discussion of the rise of good governance on the policy agenda of major donors of development assistance in this paper makes clear that there are certain ambiguities in contemporary development policies aiming at good governance. By way of conclusion, I focus on three important ones, of increasing abstraction: ambiguities in the development policies themselves, the absence of a strategy to improve governance in developing countries, and the lack of attention for the causes of bad governance in developing countries.

The increased emphasis on good governance in development policies since the early 1990s has produced some ambiguities that are, as yet, unsolved. First, most donor countries and agencies seem undecided as to whether good governance should be seen as instrumental (to economic growth or to greater effectiveness of development assistance) or as an end in itself. In donor policies there appears to be an emphasis on the first interpretation, which sees governance as instrumental. This assumption makes policies vulnerable for possible counterclaims such as those made by Hansen and Tarp (2000: 104) that 'aid improves economic performance ... even in countries hampered by an unfavourable policy environment'. Second, there is the ambiguity related to the allocation of aid *per se*. As demonstrated by, among others, Alesina and Dollar (2000) the allocation of aid to developing countries appears to be determined at least as much by political and strategic motivations of the donor countries, as by the needs and performance of the recipients. Finally, there is the

ambiguity of policy coherence of industrialised countries in a wider sense. Development assistance is provided to developing countries against the background of persistent protection markets of the industrialised countries. Some calculations show that the value of trade that is lost to developing countries because of trade restrictions in the North may be over \$100 billion or more than double the amount the former countries receive in aid (Oxfam 2002: 96).

Despite the increased attention to the quality of governance in developing countries, there is a glaring absence of strategies to improve governance. As Pronk (2001: 627) has put it: 'To use aid as a reward for good development governance may indeed be justified under certain circumstances, but often such conditions can only be met with some outside help.' One of the main risks of selectivity as a principle of policy is that it rewards countries that are already performing better in terms of governance at the detriment of countries that need to improve.

Taking this point one step further it should be noted that, despite the centrality of governance in the development discourse, there is a lack of attention for the deeper causes of 'bad governance' in developing countries. Moore's analysis of political underdevelopment is particularly relevant here. Moore (2001: 387) argues that 'the states of the South are different from those of the North because they emerged into an international environment already dominated by the relatively rich and powerful Northern states'. Historically, the state in industrialised countries maintained close links with society because it depended on society for its revenues (taxes). This resulted in the creation of a professional bureaucracy and provided an incentive for the creation of representative government.

The development in the developing countries was, however, quite different, as state and society stayed disconnected. The state came to depend on 'unearned income', deriving, first, from raw materials and later also from aid (Moore 2001:401). Because the state was not becoming dependent on the citizens for its income, there was no need for mechanisms of accountability. This historical development of the state helps to explain, to an important extent, the bad governance of many contemporary developing countries. The failure to bear in mind the fundamental causes of bad governance may make development assistance policies self-defeating.

1. Since their publication, Burnside and Dollar (1997) and World Bank (1998) have been criticised in various publications. Some of these are: Guillaumont and Chauvet (2001) and Easterly et al. (2003).
2. This and further quotes from documents in Dutch were translated by the author.
3. In addition to the CPIA index, which counts for 80 per cent, the World Bank's Annual Report on Portfolio Performance (ARPP) measuring a country's implementation performance and counts for 20 per cent, is used in the calculation of the initial performance rating (International Development Association 2003a: 1-2).
4. The criteria for IDA eligibility are: 1. relative poverty (GNP per capita below \$875); 2. lack of creditworthiness to borrow on market terms; and 3. good policy performance, defined as the implementation of economic and social policies that promote growth and poverty reduction (International Development Association 2003b).
5. It is not clear whether the introduction of the governance factor, which followed on the application of the so-called 'governance discount' in the 2000-2002 period, has answered to the criticism levelled at this measure by the World Bank's Operations Evaluation Department. The OED criticised the governance discount because it 'did not capture some countries with famously poor governance – some of which nevertheless had their lending programs curtailed, while others did not. In other words, the governance discount seems, in practice if not in intent, simply to further reduce IDA allocations to the lowest ranking performers in the CPIA exercise overall.' The verdict of the OED on the governance discount is harsh: 'Overall, the governance discount system does not work, although it does send a message that IDA takes governance matters seriously' (Operations Evaluation Department 2001: 31).

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