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The New Role for the World Bank

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The World Bank was founded to address what we would today call imperfections in international capital markets. Its founders thought that countries would borrow from the Bank temporarily until they grew enough to borrow commercially (NAC 1946, p. 312; Black 1952). Some critiques and analyses of the Bank are based on the assumption that this continues to be its role. For example, some argue that the growth of private capital flows to the developing world has rendered the Bank irrelevant.

However, we will argue that modern analyses should proceed from the premise that the World Bank's central goal is and should be to reduce extreme poverty, and that addressing failures in global capital markets is now of subsidiary importance. The Bank's stated goal is reducing poverty. The overwhelming majority of Bank subsidies from its shareholder countries go to the International Development Association (IDA), its arm for making grants and highly concessional loans to the lowest-income countries. The Bank's greatest impact comes from its role in the dramatic policy changes many developing countries have undertaken in multiple sectors that most economists would consider likely to reduce poverty, either by increasing growth or promoting equity.

Why might donor countries choose to work through an international organization to advance the goal of reducing poverty? Effective aid often involves

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negotiating agreements with recipient country governments that include policy reforms. There are economies of scale in negotiating such agreements that can be realized by an entity such as the Bank, and pooling funds into such an entity may also improve donors' collective bargaining position in negotiations with governments. Moreover, we argue that the World Bank's status as a multilateral organization and its technocratic staff enhances its credibility and legitimacy in policy discussions with developing-country governments. This has allowed the Bank to have tremendous policy influence relative to the explicit and implicit subsidies it receives, making it a bargain for those who value its mission of reducing extreme poverty and share its mainstream economic views on what policies best advance that goal.

In this paper, we discuss what the Bank does: how it spends money, how it influences policy, and how it presents its mission. We argue that the role of the Bank is now best understood as facilitating international agreements to reduce poverty, and we examine implications of this perspective. For example, the Bank should not conceptualize its principal activity as capital investment, but instead should consider a broader range of activities and instruments. Moreover, attempts to measure the Bank's success by regressions that use economic growth rates as the dependent variable and disbursements of aid as an explanatory variable will inevitably be quite misleading.

The Cost of the World Bank and Its Focus on Poverty

The World Bank Group operates through divisions with differing roles. Three of these can arguably be interpreted either through the narrow lens of addressing international capital market imperfections or through the broader lens of poverty reduction: the International Bank for Reconstruction and Development (IBRD), which lends to governments; the International Finance Corporation (IFC), which invests in commercial projects; and the Multilateral Investment Guarantee Agency (MIGA), which sells insurance policies to private investors against noncommercial—that is, political—risks. The IBRD, IFC, and MIGA work primarily in middle-income countries, with financial terms ostensibly close to market terms. Their books show them earning profits. However, they receive an implicit subsidy because they have the use of capital that shareholder governments have placed with the Bank, and IBRD shareholder governments also cover the risk that enough deals could go bad that the Bank would need to call on their pledged capital. As discussed below, academics have debated the extent to which those components of the Bank are addressing international capital market failures as opposed to simply providing subsidies.

Other parts of the Bank do not seem focused on addressing capital market failures but are more easily understood as contributing to poverty reduction. These include the Bank's fourth arm, the International Development Association (IDA), and various Trust Funds that the World Bank administers on behalf of donors. IDA was established in 1960. Instead of requiring market interest rates, IDA offers a combination of grants, along with loans on such highly concessional terms that they amount to grants, for very low-income countries, currently defined as those with per capita income of less than $1,215 per year (at market exchange rates). The World Bank Group also holds Trust Funds supported by donors and used for pre-specified purposes such as fighting AIDS and malaria, immunizing children, or promoting access to education in the developing world. In general, Trust Funds are not intended to generate financial returns.

Table 1 shows a breakdown of the opportunity cost of capital to shareholder governments. The first few rows show the paid-in capital from governments to the IBRD and the IFC, along with the retained earnings that have been accumulated over time from past repayments of loans or liquidating other investments. The first row under "Flows" multiplies the stock of $64.8 billion by 3 percent (approximately based on the 20-year Constant Maturity US Treasury interest rate) to estimate $1.9 billion per year in opportunity cost in the foregone interest from investing in a riskless security. This analysis follows the method of Meltzer (2000) and the Commission on the Role of the MDBs in Emerging Markets (2001), updating their results.

In the second row under "Flows," we estimate the cost of IDA at $8.0 billion, representing annualized donor replenishments over the last decade. The remaining flows describe disbursements from the trust funds. Specifically, we exclude "financial intermediary trust funds," which are pass-through accounts for operations outside the Bank, and include "Bank-executed trust funds," which directly finance Bank operations. The remaining category, "recipient-executed trust funds" (RETF), mixes support for Bank and non-Bank activities. We thus provide estimates with and without RETF disbursements.

The last few rows of Table 1 show an extremely rough estimate for the risk that the Bank might call on its shareholders for additional capital. According to the rules of the World Bank $218.8 billion in capital could be called, although no such call has ever occurred. Current outstanding World Bank loans total $152 billion. As a hypothetical example, if one-third of those loans default completely, representing a loss of $51 billion, $42 billion of this loss could immediately be covered by the existing stock of IRBD capital, leaving $9 billion to be drawn from the callable capital. If the risk to callable capital is equivalent to a 5 percent annual risk of an event such as this, the implicit subsidy paid to cover the risk of such high losses would be about $0.5 billion per year.

Overall, Table 1 estimates that the total subsidy provided by the World Bank Group's shareholders to clients overall is in the range of $11.0–14.2 billion per year, which includes a conservatively large allowance for risk to donors' callable capital. The range in this estimate reflects uncertainty about what portion of recipient-executed trust fund disbursements support operations of the Bank itself. Of this total, aid given through IDA accounts for $8 billion, and most of the $3 billion from recipient-executed trust funds supports activities in IDA-eligible countries (Huq 2010). The vast majority of the donor subsidy goes to very low-income countries. Further details, including our treatment of MIGA and callable capital, are described in the online Appendix available with this paper at http://e-jep.org. To

Table 1
The World Bank Group's Opportunity Cost to Its Shareholders

	US dollars (billions)	*Line*	*Calculation*	*Source*
Stocks				
IBRD				
Paid-in capital	14.0			*a*
Retained earnings	28.3			*a*
Total IBRD	**42.3**	(1)		
IFC				
Paid-in capital	2.5			*b*
Retained earnings	20.0			*b*
Total IFC	**22.5**	(2)		
Total IBRD and IFC	**64.8**	(3)	(1) + (2)	
Flows				
Annual opportunity cost, IBRD+IFC	1.9	(4)	(3) × 3%	
Annual IDA partner grant contribution	8.0	(5)		*c*
Annual trust-fund disbursements				
Bank-Executed Trust Funds (BETF)	0.6	(6)		*d*
Recipient-Executed Trust Funds (RETF)	3.3	(7)		*d*
Annual total cost to donor countries				
without RETF	**10.5**	(8)	(4) + (5) + (6)	
with RETF	**13.7**	(9)	(8) + (7)	
Risk				
Stock: IBRD callable capital (never called)	*218.8*			*a*
Flow: 20-year annual called capital if 1/3 of World Bank loan portfolio never repaid	0.5	(10)		*e*
Total Donor Subsidy				
Annual donor subsidy including risk	**11.0–14.2**		(8, 9) + (10)	

Sources: Sources given in the footnotes.
Notes: Sums of numbers appearing in table may not exactly equal sums shown due to rounding.
[a] World Bank, *Annual Report 2014*, IBRD/IDA Management's Discussion & Analysis and Financial Statements, p. 15.
[b] IFC *Annual Report 2014*, p. 103. Note that the IFC has no callable capital.
[c] Annual average of partner grant contributions in last four IDA replenishments (IDA14 [FY06–08] US$18.0bn; IDA15 [FY09–11] US$25.1bn; IDA16 [FY12–14] US$26.4bn; IDA17 [15–17] US$26.1bn). From the respective IDA Replenishment final reports.
[d] World Bank (2013), *2013 Trust Fund Annual Report*, Concessional Finance and Global Partnerships Vice Presidency, p. 38. We exclude "Financial Intermediary Trust Funds," which pass through the Bank but are not controlled by it.
[e] Current outstanding World Bank loans US$152bn; 1/3 loss means $51bn one-time loss; $42bn of this could be covered with current IBRD paid-in capital and retained earnings; thus $9bn must be drawn from callable capital. Loan maturities range from 8 to 30 years, thus loss spread over approximately 20 years. $9bn/20yrs ≈ $0.5bn/year in ongoing subsidy to offset risk.

be clear, this $11–14 billion is not an estimate of the degree to which the Bank benefits its client countries, nor an estimate of the Bank's cost of capital. Rather, Table 1 estimates the opportunity cost to the Bank's shareholders that arises from the existence of all parts of the Bank.

The World Bank's Policy Role

The annual donor subsidy embodied by the World Bank, on the order of $11–14 billion, is trivial relative to the economies and budgets of recipients and donors. Focusing on these financial flows misses a key part of what the Bank does, for good or ill, in shaping developing-country and donor policy. Here are a few examples.

Agriculture. In the past, many African farmers could only sell to agricultural marketing boards that operated state-run processing facilities and paid a fraction of the world price for export crops. For example, Ghanaian cocoa farmers shortly after independence were only receiving 55 percent of what the board received for selling their produce; Kenyan cotton farmers in the mid-1970s were getting only 48 percent (Bates 1981, pp. 137–140). This practice was common: nine of the ten African countries examined by Kherallah, Delgado, Gabre-Madhi, Minot, and Johnson (2002) had created agricultural marketing boards. The state also ran markets for inputs, such as fertilizer, often delivering them not at all, or only to politically connected farmers, or too late for planting (Lundberg 2005; Lele and Christiansen 1989). The Bank promoted liberalization of agriculture and these monopsonistic agricultural marketing boards are now mostly gone. Seven of the nine countries surveyed by Kherallah et al. (2002) have removed or reformed their state marketing boards.

Health. The World Bank promoted a shift in budgets away from tertiary-care hospitals in capital cities towards community health centers and rural clinics providing basic primary care (Ekman 2004)—for example through Ethiopia's Health Extension Program and Brazil's Family Health Extension Program. Health budgets are now substantially more oriented toward primary care. At one point the Bank pushed for charging fees to at least certain categories of patients, although it has now backed away from this (World Bank 2015a). It now frequently promotes the adoption of pay-for-performance programs within government health services.

Education. The number of out-of-school children and adolescents worldwide fell from 196 million to 124 million between 2000 and 2013 (UNESCO 2015) despite population growth over the period. The Bank has been an important part of the movement for universal primary education, and now that the vast majority of primary-school-age children in the developing world are enrolled in school, the Bank is shifting its focus to improving learning.

Social protection. The Bank has played an important role in the spread of "conditional cash transfer programs"—in which cash transfers to low-income households are linked to children attending school or seeing health care providers. After promising results from Mexico's PROGRESA in the 1990s (now referred to as

Oportunidades) and Brazil's Bolsa Alimentação program, the Bank now supports conditional cash transfer programs in 26 countries (World Bank, undated). The Bank both financially supported national programs and vigorously promoted conditional cash transfer programs, including at international conferences convened for that purpose in Mexico in 2002, Brazil in 2004, and Turkey in 2006. The Bank's researchers also played an important role in rigorously evaluating the impact of these programs, a factor in their rapid diffusion. Such programs have been found to reduce poverty and improve child health and education (Fiszbein and Shady 2009, p. 14).

Regulatory policy. The World Bank's *Doing Business* reports, which provide objective and internationally comparable measures of how different countries regulate the private sector, have been very influential in motivating countries to reduce regulatory barriers to establishing new firms (in this journal, Besley 2015).

Tax policy. While the International Monetary Fund has played a bigger role, the World Bank has supported the dramatic worldwide shift to value-added taxes, which have replaced other taxes widely considered less efficient. Since 1960, a VAT has been adopted as the main consumption tax in over 140 countries (Norregard and Khan 2007; Cnossen 1998).

Trade policy. The World Bank, along with the IMF, has supported shifts from rigid import quotas to more flexible tariffs, along with reductions in tariffs and movements toward "unified" exchange rates in which the same exchange rates are applied to all types of trade. From the 1980s to 1990s, most World Bank adjustment operations were made conditional on trade liberalization (Edwards 1997). Tariffs and statutory barriers to business creation have declined dramatically. In India, for example, the weighted tariff rate has fallen from 54 to 7 percent between 1990 and 2009 (World Bank 2015b).

Conflict recovery. In post-conflict situations, the Bank has supported community-driven development programs and procedures for demobilizing and providing transitional support to ex-combatants, for example, in Bosnia, Cambodia, El Salvador, Lebanon, and Uganda (Kreimer et al. 1998, p. 28).

Property rights. Since the 1960s, the Bank has supported land demarcation and titling programs in Armenia, Bolivia, Guatemala, Indonesia, Malawi, and elsewhere across the developing world (World Bank 2011). Thailand used World Bank support to partition and distribute land to rural residents (Bowman 2004). Whereas governments of developing countries once regularly appropriated private assets, they are now more likely to privatize state assets.

This list of policy areas where developing countries have dramatically changed policies following Bank involvement suggests that an important way to judge the Bank is a) the extent to which the Bank played a causal role in these changes and b) whether these policy changes were appropriate and effective in reducing poverty. We will discuss some of this evidence below, although it is not the main focus of this paper. Indeed, we do not agree with all of these policies or believe they were all well implemented, but we do agree with the general thrust of most of them and believe that they reflect mainstream views within the economics profession.

Assessing the extent to which World Bank actions played a role in the policy changes listed above is of course difficult. Global changes in international relations and in ideology have surely played a role. But there is reason to believe that the Bank accelerated the changes above. Take the spread of conditional cash transfers. While these programs were a Brazilian and Mexican innovation, early World Bank evaluations and promotion of conditional cash transfer policies gave them credibility and legitimacy before a worldwide audience (Fiszbein and Schady 2009; Borges Sugiyama 2011; García and Moore 2012; Ancelovici and Jenson 2013). The Bank also directly financed and helped design such programs in Colombia, Jamaica, El Salvador, Panama, Guatemala, Chile, Senegal, Eritrea, Burkina Faso, Cape Verde, Democratic Republic of the Congo, Ethiopia, and others (Handa and Davis 2006; García and Moore 2012; Pena 2014).

Gavin and Rodrik (1995) conclude that "the Bank is the single most important external source of ideas and advice to developing-country policymakers." This view has empirical support from a survey of 6,731 government officials and development practitioners, from 126 low- and lower-middle-income countries, who were asked for subjective ratings of 57 different aid agencies (Custer, Rice, Masaki, Latourell, and Parks 2015, p. 48). The World Bank ranked first out of 57 for "agenda-setting influence" and fifth for "usefulness of advice." The Bank's lending operations undoubtedly play an important role in its influence. But in our view, the Bank's influence is much larger than what the $11–14 billion effective subsidy, taken in isolation, might be expected to purchase.

The World Bank magnifies its policy influence through a variety of mechanisms. At the national level, the World Bank chairs groups of bilateral donors that negotiate with recipient-country governments. When the Bank withdraws support from a particular government ministry, other donors often follow. This pattern gives the Bank considerable power to influence overall donor flows, and additional leverage in negotiating with client governments. Beyond this, the Bank plays an important role in how ideas move into policy by collecting data, generating ideas, bringing ideas to a wider policy audience, and turning the ideas into specific policies. At the global level, the Bank sets agendas with publications such as the *Doing Business* reports and the annual *World Development Report*. Many national leaders, including Narendra Modi in India and Vladimir Putin in Russia, have explicitly aimed to improve their standings in the *Doing Business* reports by removing barriers to business investment (Besley 2015).

The World Bank's influence derives in large part from its "soft power," by providing a context and a venue for independent policy discussion. In many of the countries where the Bank operates, political competition is focused on patronage or ethnic and cultural issues rather than economic policy. Think tanks are scarce, and the senior civil service is stretched thin. In this environment, Bank staff can have tremendous influence. The Bank recruits internationally and pays salaries higher than those in most civil services, allowing it to attract staff with very strong qualifications. Staffers come from a variety of countries, including developing countries, and are not seen as promoting a single national perspective. Bank staff have access to policymakers and often build relationships of trust with key civil servants. Politicians will make the overall decision about whether, say, a conditional cash transfer policy should be implemented. But the World Bank can then have huge influence on decisions regarding the details and implementation of the program. When civil servants debate policy options, those who can argue that their preferred position complies with international norms may be less likely to be seen as merely advocating a position designed to advance their personal and bureaucratic interest (Mukand and Rodrik 2005).

A main channel of World Bank influence, and a measure of the Bank's prestige, is the flow of Bank staff to senior policy-making positions in their home countries (Krueger 1998). Frequently mentioned recent examples include: Ngozi Okonjo-Iweala in Nigeria, Luisa Diogo in Mozambique, Montek Ahluwalia in India, Kemal Derviş in Turkey, Richard Webb and Luís Miguel Castilla in Peru, Ellen Johnson Sirleaf and Antoinette Sayeh in Liberia, Moeen Qureshi in Pakistan, Vittorio Corbo in Chile, Ashraf Ghani in Afghanistan, Benno Ndulu in Tanzania, and many others. Former World Bank staffers Suman Bery, Shankar Acharya, and Jayanta Roy played key roles in enacting India's 1991 reforms (Sengupta 2009), contributing to one of the largest reductions in poverty on record.

The Role the World Bank Has Come to Fill

The founding rationale for the World Bank, in sharp contrast to the activities above, was explicitly to address failures in capital markets. But it has been clear for some time that the Bank has evolved beyond that role.

The iconography of the Bank offers clues to what the Bank itself thinks it should do. The motto "Our dream is a world free of poverty" is carved in stone at the Bank's entrance. A three-story-long red HIV ribbon hung on the Washington headquarters of the World Bank in recent years. The bright atrium of the Bank's headquarters features only one monument—not a scale model of an infrastructure project financed by Bank capital, but a commemoration of the Bank's first health project, in which its central role was one of convening and coordination. It is a sculpture honoring the effort to control river blindness, portraying a young African boy leading an older man afflicted by the disease.

The Bank's rhetoric conveys a similar purpose. Four decades ago, then-President Robert McNamara (1973) set the central goal of eradicating absolute poverty, and proceeded to reshape the Bank's operations around interventions that included massive support for smallholder agriculture. The current Bank President Jim Yong Kim describes the dual mission of the Bank as ending extreme poverty by 2030 and boosting prosperity among the poorest 40 percent in low- and middle-income countries.

Providing grants and subsidies to the poorest countries through IDA can clearly be seen as furthering this mission. Even within the IBRD, many loan projects are focused on poverty. For example, 72 percent of current Brazilian IBRD projects are in the relatively impoverished Northeast and North regions, home to only 36 percent of Brazil's population (World Bank 2015c). Conditional cash transfers are another example of the World Bank's interest in explicitly poverty-focused programs within middle-income countries.

World Bank lending to middle-income countries that can borrow internationally like Brazil seems more difficult to justify based on the original view of the Bank as addressing failures in international capital markets. Bank clients including Brazil, Thailand, Indonesia, and Mexico could easily self-finance all their IBRD loans without meaningfully depleting their international reserves. China provides an extreme example. In mid-2015, China owed the World Bank $13 billion, but held $3.7 trillion in cash reserves. For the many countries that borrow both from the Bank and on purely commercial international capital markets, it is not clear that the Bank is helping improve access to capital. This is true even if the Bank lends at cheap rates due to its superior ability to secure repayment (Bulow and Rogoff 1990). To the extent that Bank loans are senior to commercial loans, countries' ability to borrow from the Bank may simply drive up their cost of borrowing commercially, leaving their overall cost of lending unchanged. This insight has led some researchers to suggest ending most Bank lending to middle-income countries (for example, Bulow and Rogoff 1990, 2005; Meltzer 2003; Einhorn 2006).

However, if one sees the key rationale for the World Bank as addressing extreme poverty, then a different rationale arises for the Bank's continued work in middle-income countries. In 1990, only one-quarter of the world's extreme poor—those living on less than $1 a day at purchasing power parity exchange rates—lived in middle-income countries. Today, with more countries in the middle-income category, about three-quarters of the extreme poor live in middle-income countries (Sumner 2012a). Even as poverty reduction in middle-income countries proceeds in the next decade or two, the majority of the world's extreme poor will continue to be found there (Sumner 2012b). Furthermore, the poor within many middle-income countries are concentrated in specific geographic areas or subnational states or provinces—like certain poor states in India. The Bank could also target sectors of particular importance to poverty reduction, such as social protection.

This rationale for World Bank lending to middle-income countries raises the question of whether such loans actually increase total funds received by the poor. One could easily write down a model in which World Bank lending reduces the amount of its own resources that, say, Brazil transfers to poor areas. Of course, one could also write down a model in which the Bank could negotiate with the Brazilian government and provide lending only if the government also increased spending. This would be an international version of the "flypaper effect" in public finance, in which federal grants fail to fully "crowd out" local-government expenditures. Such effects have certainly been observed in various public-finance settings (in this journal, Hines and Thaler 1995), but research is needed on the extent to which it occurs in the development lending-and-aid setting. Defining the Bank's role in middle-income countries will become more pressing as about half of IDA's member countries are on course within a decade or so to reach the threshold of per capita GDP where they will graduate to IBRD status (Moss and Leo 2011).

The subsidy element in Bank financing is small enough that the transfer element could make only a very modest impact on poverty on its own. An estimated 2.7 billion people live on less than $2 per day (measured using purchasing power parity exchange rates), so if Bank lending had a donor-subsidy element of $11–14 billion, and was perfectly targeted to the poor with no administrative costs, it would increase incomes of the poor by only about $4–5 per year. Again, the Bank's policy role seems much more closely related to its poverty reduction mission than to a narrow focus on addressing international capital market imperfections.

While we have focused on the Bank's articulated mission of reducing extreme poverty, there is also clear evidence that influential World Bank member countries use the institution to advance their interests. From the beginning, the World Bank had a political mission—to use aid to keep countries in the Western political orbit and to compete with the USSR for economic and political influence in third world countries—as well as a narrower economic mission. The political nature of the institution has continued. In particular, the United States has effective veto power over major Bank decisions, and Bank lending tends to follow the commercial and financial interests of the United States (Faini and Grilli 2004; Fleck and Kilby 2006; Kilby 2009). Indeed, US officials explicitly demanded such behavior in recently declassified documents from long ago (McKeown 2009). Also, countries temporarily on the UN Security Council receive more Bank loans (Dreher, Sturm, and Vreeland 2009), and Bank projects may be used to reward countries for General Assembly votes that support priorities of the United States and other high-income countries (Dreher and Sturm 2012). The United States has successfully intervened to limit Bank lending to some countries, including Iran.

In addition, the Bank's choice of anti-poverty policies on which to focus also reflects the interests and domestic politics of key shareholders. For example, the Bank has played a much more active role in arguing that countries should have more open trade policy than in arguing for more open migration policy, a choice that likely arises from reasons of politics more than from reasons of relative effectiveness in reducing global poverty. One of the Bank's technical assistance projects for an agreement on seasonal labor migration from poor South Pacific islands to New Zealand (Luthria and Malaulau 2013) underwent rigorous impact evaluation and was called "among the most effective development policies evaluated to date" (McKenzie and Gibson 2010). But this project has not received much attention, nor has it been followed by major new Bank investments in labor mobility. Of course this may also reflect Bank staff's judgment about the areas where it may have scope to be effective.

Why a Multilateral Organization?

Consider a context in which high-income countries each put some value on certain outcomes in low- and middle-income countries. These low- and middle-income countries also have preferences and make decisions affecting those outcomes. For example, high-income countries may value alleviating extreme poverty or addressing more specific needs in the developing world, such as education of girls or provision of treatment for those infected with HIV. That value could arise through two separate channels. First, policymakers in high-income countries may believe that conditions in low- and middle-income countries will generate externalities for high-income countries through mechanisms such as terrorism, disease, or migrant flows. Second, policymakers and citizens in high-income countries could directly value certain outcomes in poorer countries. Altruism appears to be an important driver of charitable giving, including in international settings (Cox, Friedman, and Sadiraj 2008; Null 2011; DellaVigna, List, and Malmendier 2012). If Canadian giving reduces infant mortality in Bangladesh, and if Swedes value reductions in infant mortality anywhere in the world, then Canadian giving generates benefits not only for Canada, but also for Bangladesh and for Sweden. Thus theorists from Becker (1974) to Coate (1995) explicitly classify poverty alleviation under altruistic preferences as a public good. The development literature frequently considers poverty alleviation itself as a public good with worldwide reach (Azam and Laffont 2003; Torsvik 2005; Bourguignon and Platteau 2015).

When global public goods are both cause and result of poverty alleviation, multilateral giving can become an efficient choice. For each high-income country acting individually, the optimal rule is to spend on development assistance until the marginal benefit to each particular high-income country of expenditure abroad equals the marginal domestic benefit. Conversely, the low-income country would set the marginal utility of expenditure on the internationally valued good (such as girls' education) equal to that on other goods valued by the developing-country policymaker. But the standard Samuelson (1954) rule suggests that for public goods, it is *collectively* optimal to spend until the total marginal benefit to all countries of expenditure equals the benefit of alternative expenditures. Individual countries have a strong incentive to free-ride on the poverty-alleviation caused by others, resulting in inefficiently little provision of poverty alleviation from the standpoint of each donor individually. This insight suggests large potential gains from coordination.

If global public goods related to poverty alleviation are undersupplied when countries make decentralized decisions, then a global institution like the IDA can address this problem through donor coordination. Contributions are set according to an agreed formula. Once the formula is established, an increase in the contribution from one country, like the United States, is linked to an increase from others. Attempting to achieve this result with a treaty on donor coordination, requiring each nation to follow up individually, would necessarily be an incomplete solution.

Enforcing Mutually Beneficial and Hard-to-Monitor Coordination

Consider first the example of "tied aid," in which countries create policies requiring that part of their aid spending be spent on goods and services supplied by their own firms. For example, in 2009, 67 percent of Greece's foreign aid required the use of Greek contractors (OECD 2011, p. 12). Suppose that when a donor ties aid, a fraction of any aid spending comes back to the donor country but the effectiveness of that aid declines. Donors collectively might be better off joining a pact in which they promise to untie all their aid. If donors are in symmetric positions, then in equilibrium each donor's firms will get just as much business—they can get hired by other donors no longer tied to their own firms—but the resulting increased efficiency of aid raises utility for all donors. Indeed the 2005 Paris Declaration on Aid Effectiveness (OECD 2005/2008) seeks to reduce tying of aid. However, such an agreement may be hard to enforce. For example, donors may focus on funding sectors in which their own firms are well-placed to bid on contracts. Agricultural exporters like the United States could decide to give aid in the form of food, thus promoting their commercial interest. China could give aid for transport infrastructure that facilitates trade with China. Given these kinds of alternatives, a collective agreement for nations to pass their funding through a multilateral organization may be a more enforceable way to move away from tied aid. Similarly, individual donors acting through bilateral development organizations might want to give preference in hiring to their own citizens. Just as with tied aid, a multilateral system that hires from all countries raises the possibility that (in a symmetrical situation), aid effectiveness would improve and no nationality would necessarily be worse off.

Individual incentives among donors also lead to excessive fragmentation of donor effort. Bilateral donors will engage in "flag-planting"—that is, they will want to have identifiable and specific aid projects of their own that raise the profile of their individual agency, even though such fragmentation of aid efforts comes with an efficiency cost.

Avoiding Duplication and Achieving Economies of Scale

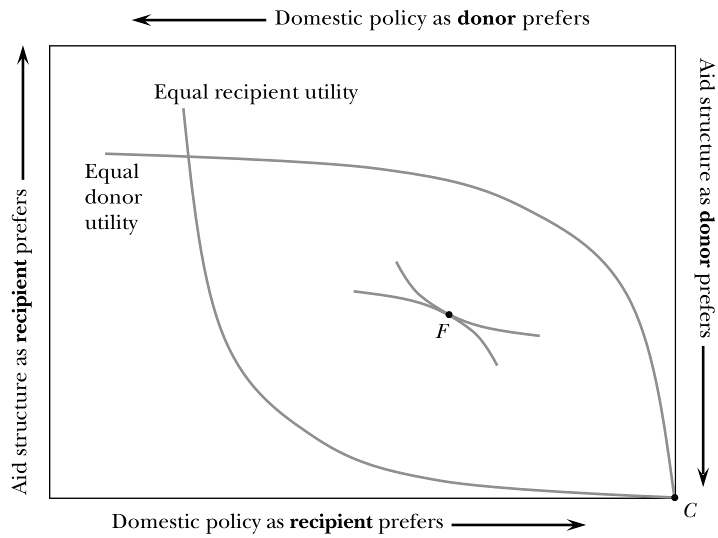
There are important economies of scale and scope in multilateral aid institutions (Sandler 2002; Kanbur 2004; Martens 2005). For example, it would be pointless and wasteful for each individual donor country to undertake its own version of the World Bank's macroeconomic due diligence and poverty-mapping work. It is more efficient for nations to pool their resources and purchase one "aid product" they can all share.

The Bank is able to attract talent in part because it recruits internationally, which typical bilateral development agencies do not do. For any given policy discussion, the World Bank has greater embodied experience in the room—that is, people with personal and professional experience of the issue and place at hand—than most bilateral agencies. Further economies of scale arise for a multilateral aid agency if one takes into account how aid recipient countries must handle accounting so as to comply with the requirements and fiscal years of many different national systems, which can divert substantial resources from other tasks. For example, aid programs in Tanzania are hampered by quarterly accountability reports that the Tanzanian government must submit for over 2,000 donors (Ritzen 2005).

Exploiting Gains from Policy Trade

When donors control some instruments and national governments control others, there will in general be opportunities for gains from negotiations between donor countries and recipient governments to reach the Pareto frontier. Imagine

Figure 1
Pareto-Improving Deal between a Donor and Recipient



Notes: When donors control some instruments and national governments control others, there will in general be opportunities for gains from negotiations between donor countries and recipient governments to reach the Pareto frontier. The potential for gain can be represented in an Edgeworth box. Without negotiation, donor and recipient could start at point *C*, with the donor in full control of aid structure and the recipient in full control of domestic policy. But both parties could achieve higher utility at point *F*, with the donor making concessions on aid structure and the recipient on policy.

that there are two parties, *A* and *B*. Party *A* has full control of the instrument *a,* and party *B* has full control over instrument *b*. Thus, for example, party *A* may be Ghana and instrument *a* might include domestic policies like central bank independence, tariffs, legal requirements for transparency in procurement, free speech, girls' education, transfers to the extreme poor, employment for youth subject to radicalization, and the content of the curriculum in teacher training colleges. Party *B* might be Sweden, and instrument *b* is the amount, sector, and financing terms of Swedish aid offered to Ghana. Both parties have preferences over both instruments.

The potential for gain can be represented in the Edgeworth box of Figure 1. Moving left from the upper-right origin means that domestic policy more closely follows donor preferences, while moving right from the lower-left origin means that domestic policy more closely follows recipient preferences. Moving down from the upper-right origin means that aid structure more closely matches donor preferences, while moving up from the lower-left origin means that aid structure more closely matches recipient preferences. Donor and recipient make tradeoffs according to the indifference curves shown. Without negotiation, donor and recipient could start at point *C*, with the donor in full control of aid structure and the recipient in full control of domestic policy. But both parties could achieve higher utility at point *F*, with the donor making concessions on aid structure and the recipient on policy.

This claim of potential gains does not rest on paternalism—that is, on a claim that the preferences of donors are superior to those of recipients. For example, the government of India presumably cares more about the welfare of the representative citizen in its states of Punjab and in Bihar than does Germany, but Germany likely puts greater relative weight on a dollar of extra GDP for (poorer) Bihar than for (richer) Punjab, than does India. This does not mean that Germany's preferences are superior; it is natural and legitimate for India to value the welfare of its citizens in Punjab. Rather, the opportunity for Pareto improvement arises from the combination of divergent, legitimate preferences and different control over different instruments—such as policies that would help those in Bihar more, or less, than those in Punjab.

Reducing Negotiation Costs of Policy Trade

A deal could potentially be struck at any point between the curves in Figure 1. What point within that area is chosen (or even whether the parties reach an agreement) will depend in part on the relative bargaining strengths of the two parties and how efficiently they bargain. Reaching an efficient bargain requires work. Ideally, negotiations between (say) Ghana and Sweden would look at every policy instrument under Ghana's control and figure out which potential policy changes are most valuable to Sweden and lowest cost for the Ghanaian government to change. Ideal negotiations would simultaneously look at how the amount and composition of Swedish aid to Ghana could most effectively be tweaked to make it more attractive to the Ghanaian authorities while diminishing its appeal to Swedes by as little as possible. The prospect of costly and time-consuming negotiations along these lines for every bilateral aid donor giving to each recipient suggests that it can be efficient for donors to create an institution with shared governance among the donors, such as the World Bank, and to have that entity negotiate with the recipient country.

A multilateral institution can reduce asymmetries of information, increasing the chance of an efficient bargain. If the donors have information that a change in policy in a direction preferred by the donors might be very low cost or even beneficial from the point of view of the recipient country authorities, they would want to find a way to credibly transmit this information. Suppose, for example, that the donors are trying to persuade an oil exporter to drop domestic gasoline subsidies. Donors might want to produce evidence to make their case, but the recipient government may be reluctant to trust the arguments of an official from a bilateral aid agency. They might be much more willing to trust a Brazilian World Bank official with a PhD from University of California at Berkeley who has been involved in similar reform efforts in eight other countries. They might also be willing to trust a series of World Bank publications that review the literature and discuss the range of policy options (including different kinds of phase-outs, targeting, and offsetting policy changes).

Many pathologies can arise in a decentralized aid setting with many small donors. For example, in a decentralized game, a recipient country government might respond to donor spending in a sector by cutting back its own spending. For example, Pack and Pack (1993) find an inverse correlation between changes in domestic expenditure on health and education and new donor aid to those sectors in the Dominican Republic. Donors may obtain better outcomes if they collectively negotiate with the national government, with the implicit threat point of taking their aid spending to another country if a government is inflexible. They may well be able to crowd in additional government spending in areas of mutual interest. Bilateral aid agencies may not be able to make a credible commitment to walk away from countries where a donor government has a foreign policy interest.

Dialogue and exploring options may be particularly helpful in reaching the Pareto frontier. Exploration might reveal some forms of expenditure that advance the interests of the government and of multiple donors. For example, the World Bank supported a land titling program in Rwanda and, based on a pilot study, realized that women in common-law marriages were losing land titles (Ali, Deininger, and Goldstein 2014). The Rwandan government changed the program to rectify the problem. This was probably a move to the Pareto frontier for the Rwandan government, for donors who believed property rights were important, and for donors who focused on gender issues—relative to a model in which the government and different donors acted independently.

Another advantage of a multilateral organization is that the World Bank's operating directives specifically prohibit it from attempting to exert political influence, whereas there is strong evidence that bilateral donors do attempt to influence elections (Faye and Niehaus 2012). In other cases, of course, donors might want a multilateral agency to focus on these types of political issues. It might be possible to draw some rule-based distinctions for aid—for example between countries with elected governments and unelected governments, which could at least reduce country-to-country tensions that could otherwise be inflamed.

The Role of Legitimacy

In thinking about the Word Bank's success in influencing the global consensus on development policy, it is also important to think in terms of the concept of legitimacy from political science (Bäckstrand 2006). An advantage of delivering aid through international organizations such as the World Bank (or the World Health Organization) is that staff are less likely to be seen as representing the parochial interests of one particular donor, which gives them more legitimacy with the host country government (Rodrik 1996). Markets in policy advice function very poorly, because there are incentives to tell policymakers what they want to hear and what will bring in more consulting contracts—for example, advising countries on how they can use industrial policy to set up an information technology hub, rather than to promote free trade. There is little reason to believe that outcomes would be better if countries simply hired consulting firms to provide policy advice. That is not to say that there are not advantages of competition in aid provision, as in other areas of the economy (Easterly 2002), or that we have any reason to believe that the current balance between the World Bank and other development-focused organizations is optimal. We claim only that a fully decentralized market in advice would be problematic.

What Should the World Bank Do, and How Should Its Performance Be Assessed?

Should the World Bank focus exclusively on investment projects, or also support raising current consumption of the poor? When the World Bank was founded, it may have seemed that low-income countries were stuck in poverty indefinitely and that financial flows might help them escape this trap. It is harder to make that argument now. Over the past decade, average annual real GDP per capita growth has been 9.4 percent in China and 6.2 percent in India, and sub-Saharan Africa's long period of decline or stagnation in GDP performance has been replaced by a solid, if modest, 2.0 percent annual growth rate. Poorer countries in the same period have grown faster than richer countries: 3.3 percent annual growth for low-income countries, as defined by the World Bank, compared with 0.8 percent for high-income OECD countries. Some countries may be trapped in conflict or in truly dystopian oppression, but for these countries, a lack of access to capital markets is not their main problem. Indeed, run-of-the-mill bad governance is no longer enough to prevent growth. Current growth patterns may or may not persist, but over long periods the evidence for national-level poverty traps is not strong, as Kraay and McKenzie (2014) discuss in this journal (see also Easterly 2006).

If low- and middle-countries are not stuck in a poverty trap, and if donors care about goals such as ensuring that all children have access to basic education or reducing infant and maternal mortality, then it makes much more sense for donors to conceptualize foreign assistance around poverty alleviation rather than around helping countries escape from poverty traps by addressing imperfections in international capital markets.

Indeed, one can make a case that development assistance should seek to raise current consumption rather than investment. Consider a model in which the optimal path of consumption over time is determined by permanent income (that is, expected income over time) and world interest rates. In the benchmark case of this model, development assistance adds to permanent income, which in turn would increase consumption uniformly in the current and all future periods, with the growth rate of consumption unchanged. However, one can write down versions of models along these lines with different sets of constraints in which aid could lead either to more current consumption, or less. For example, if current consumption is low and credit constraints prevent the country from consuming more in the short run, then the optimal response to receiving aid would be to increase current consumption by more than future consumption, which would imply that the country would experience an immediate boost of consumption following the transfer of aid but slower growth of consumption afterwards. Alternatively, in a version of the model in which both consumption and domestic investment are constrained initially, aid flows could lead to an immediate jump in consumption and thus slower growth of consumption, but also to stimulating investment and a higher growth of GDP.

However, none of these models imply that the gains from development assistance will make a substantial difference to national growth rates. For example, consider an example in which a country saves 20 percent of its income. In this case, a transfer of 5 percent of GDP through aid will lead to a 1 percent of GDP increase in saving and investment. If the rate of return on that additional investment is 10 percent per year, GDP will be greater in subsequent years by one-tenth of 1 percent. Without exotic feedback mechanisms, there is little reason to expect effects of aid to be large or significant in cross-country regressions that use level or growth of GDP as a dependent variable (Swift 2012). Insofar as World Bank aid is a subset of aid overall, it would be even harder to pick up its effects on GDP.

Our view of the Bank as focused on negotiating with government over policies to reduce extreme poverty has implications for its internal structure. For example, to the extent that the Bank is structured on a country-level basis or donors allocate funding on a country-level basis, the Bank bargaining position vis-à-vis national governments is weakened. Conversely, to the extent that the Bank and/or donors within a country can negotiate separately with various ministries or with various levels of government in a federal structure, donors' bargaining power may be strengthened because ministries and subnational governments may compete for donor support.

This reassessment of the role of the Bank suggests that it may want to undertake additional activities beyond lending to governments. For example, the Bank may be able to most effectively fight poverty by spending on areas where both markets and governments have suboptimal incentives to spend, such as on global public goods. Areas where the Bank is already involved in production of international public goods include its support to the Consultative Group for International Agricultural Research (CGIAR); the creation of the pilot Advance Market Commitment for pneumococcus vaccine; and frameworks for cross-border negotiation of water management (Briscoe 2001) and regional labor mobility (Luthria and Malaulau 2013). Many of the Bank's infrastructure projects through the Global Infrastructure Facility have the potential for broad cross-border spillovers, such as support for fiber-optic Internet cables, mobile phone towers, export-processing zones, and airports (World Bank 2015d). Another promising area of Bank activity lies in its efforts to fight money laundering for organized crime and tax evasion through its Financial Markets Integrity unit. The Bank's provision of data—such as through its Living Standards Measurement Surveys and other survey work and its impact evaluation work—has cross-border benefits. The work of the World Bank's research department is also a global public good. A review of the Bank's research department by 28 leading development economists (Banerjee et al. 2006) found that the department had produced "some outstanding work" that has been "hugely influential on global ideas about development"—though it found visible works "where balance was lost in favor of advocacy."

The Bank could also fund scientific research to develop products the poor need, or innovation in ways to deliver development finance—including by strengthening remittance transmission and exploring opportunities for direct and unconditional cash transfers (Blattman and Niehaus 2014). It could potentially in some cases even make transfers directly to the poor, although we have argued that the Bank will typically get bigger bang for the buck through its influence on policy.

Some have argued for a Bank that is focused on international public goods, and in particular around international public goods that involve externalities other than those that are preference-based—such as focusing on climate change—rather than poverty alleviation. While we agree that a multilateral institution in general may be an appropriate place to address the provision of global public goods, some global public goods clearly have less particular relevance to the poor than others (for example, protection of arctic biodiversity or planning to reduce the risks of an asteroid striking Earth). Those who are focused on poverty alleviation, including people from low-income countries, might resist a redirection of existing Bank resources to global public goods in general as opposed to global public goods of particular importance to the poor, such as research on cassava or sleeping sickness.

If one believes that the primary impact of the Bank comes from its specific investments, then one might reasonably evaluate the Bank by assessing what proportion of its investments yield, for example, a 7 percent annual rate of return. If one believes, as we and many other observers do, that the biggest effects of the World Bank arise through its role in influencing developing country policy, then one's assessment of the overall impact of the Bank will hinge primarily on one's beliefs about the effects of these types of policies. A regular bank hopes to obtain a positive return on the vast majority of its investments. In contrast, the Bank could potentially achieve a high social rate of return through a few big wins. If one has a sufficiently favorable view of the regulatory reforms inspired by the Bank's *Doing Business* work, or its role in replacing patchworks of patronage-ridden social programs with conditional cash transfers, then one might believe that the Bank has paid its way, even if the financial performance of Bank loans overall was mediocre. By the same token, the Bank could also have an impact much more negative than the wasting of its funds if it produced harmful policy change. The "fifty years is enough" protesters who sought to close the Bank in the 1990s clearly felt that the Bank's "neoliberal" agenda is harmful, and some conservatives may not support the idea that governments of high-income countries should tap their citizens to provide aid at all. Others take the view that aid, including aid from the Bank, keeps bad governments in power.

Clearly, if one believes that the Bank has reduced poverty primarily by using its financial resources as part of a bargaining process to promote a few important policy reforms, measuring the Bank's impact becomes difficult. Running a regression with country-level outcomes as the dependent variable and World Bank lending as a key explanatory variable will miss the point if a substantial share of the Bank's impact came from the spread of conditional cash transfers, or reforms inspired by the *Doing Business* reports, or the impact of former Bank officials on Indian economic reforms in the 1990s.

Reasonable people can disagree over the specific policies promoted by the World Bank. Each of us is skeptical about some policy initiatives promoted by the Bank, and even when we agree with the overall thrust of the policy, there were often problems in implementation. The devil is often in the details: corrupt or poorly run privatizations may amount to giveaways of state assets, and charging fees at health clinics might be a false economy. But the thrust of most policies promoted by the World Bank has been in line with the mainstream thinking of the economics profession, and our judgment is that, overall, these changes have promoted both equity and efficiency. To put it another way, few economists would advocate a return to the old ways: the agricultural marketing boards; a large share of health care spending focused on tertiary-care hospitals in the capital city rather than rural clinics; higher barriers to business creation; a sprinkling of obscure fees and taxes rather than a basic value-added tax; and so on.

One could ask whether the Bank's policy role could be disconnected from its financial support and from the legitimacy provided by the Bank's status as an international organization. We agree with many observers' judgment that World Bank financing is essential to the Bank's policy influence, both as a pure carrot and as a signal of credibility (Rodrik 1996; Gilbert, Powell, and Vines 1999; Commission on the Role of the MDBs in Emerging Markets 2001; Banerjee and He 2003). Many of these arguments apply independently of whether such financial support is provided as grants or loans. Our analysis is that the Bank's choice of country-partners should take into account the extent to which it can influence policy. In some cases, such as today's Zimbabwe, country policymakers may be resistant to influence. However, donors may sometimes be able to promote poverty reduction by engaging with difficult regimes such as Myanmar that can be nudged in a good direction. Kenya's Daniel arap Moi is often portrayed as having been the paradigmatic example of a corrupt dictator with whom donors should not have engaged. Yet pressure from donors helped encourage him to accept term limits that eventually led to his peaceful departure from office. Judgment calls are inevitable. In some cases, selecting the margin of influence should proceed ministry by ministry rather than country by country.

Finally, our analysis also suggests that the legitimacy of the World Bank may play a role in its effectiveness in influencing policy. The Bank gains legitimacy from its wide membership. The Bank has taken modest steps in reforming its shareholding structure: IBRD shares controlled by developing and transition countries—which determine voting power in the institution—have risen from 43 percent in 2010 to 47 percent today. Maintaining the Bank's legitimacy will require further steps at the Bank, including breaking with the tradition that only US citizens hold its presidency (Rajan 2008) and continuing to adjust its shareholding structure to reflect the relative importance of countries in the world economy. The Bank also gains legitimacy from the perceived professionalism of the staff, including a professional research department, and this professionalism may be quite important. For example, staff with background from the research department often put together the World Bank's *World Development Report,* provide mission support to other Bank staff, and also generate documents that may be useful in interacting with the clients. The existence of a research department that publishes in journals may also attract staff, similar to Stern's (2004) finding that the opportunity to publish is important in attracting staff to biotech firms.

We believe that the World Bank is, and should be, primarily focused on poverty reduction rather than addressing capital market imperfections. While it is impossible to quantify the Bank's policy influence in a precise way, our judgment is that Bank donors are getting a tremendous amount of policy influence with their limited funding. This influence comes both through deals that link Bank finance to policy reform and through the Bank's soft power. For this reason, allocating more resources to the Bank would be desirable. Other institutions could potentially play a role similar to that of the Bank, but we believe that the Bank has considerable organizational and reputational capital, along with its remarkable track record of policy influence. We see no case for donors to consider withdrawing their funding from the Bank and reallocating it to regional development institutions.

Conclusion

Development advocates often claim that a one-time infusion of capital can generate "sustainable impact," in the sense that after a one-time infusion of funds, the project or investment will generate a stream of income into the future without additional funding. The notion that to be desirable expenditures must be sustainable is politically seductive: for example, the idea of increasing growth and addressing poverty solely by "teaching a man to fish" has comforting appeal. The idea that a temporary infusion of capital would put countries on the path to sustained growth was important for the creation of the World Bank, and it has a continuing influence in the Bank.

However, this "illusion of sustainability" can distort aid and policy decisions (Kremer and Miguel 2007). For example, it can lead to a lack of support for programs that require an ongoing investment in maintenance or management over time, because the requirement for continued funding means that it is not a one-time investment. At a deeper level, the sustainability argument views the justification for aid solely in terms of facilitating escape from poverty traps. But the rapid growth in low-income countries means it is socially efficient for them to consume more now, at least as long as marginal utility is diminishing in consumption and the welfare of the poor has a weight anywhere above the infinitesimally small.

The justification for the World Bank as an aid institution does not rely on capital market failures, or on whether a temporary infusion of capital will suffice. Instead, it is based on poverty reduction. As a multilateral institution, the Bank is well-placed to facilitate Pareto-improving and politically legitimate deals among donors and between donors and developing-country governments. The World Bank has evolved into a role that rests on economic justifications that are sound and defensible, but are profoundly different from those underlying its original stated role. Assessments of the achievements of the Bank and decisions about the Bank's future should be guided by the role the Bank has evolved to fill, and the ways in which the Bank can fulfill that role.

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