14

Foreign Aid

One of the greatest accomplishments of the past 50 years—the massive drop in the number of child deaths from 20 million children in 1960 to 8.1 million deaths last year—is an example of the tremendous progress we've made, in large part, thanks to foreign assistance. If the world comes together on a plan for financing development, the impact on health and development will be enormous. (philanthropist Bill Gates, April 2011).[1]

I have long opposed foreign aid programs that have lined the pockets of corrupt dictators, while funding the salaries of a growing, bloated bureaucracy. (U.S. Senator Jesse Helms, January 11, 2001)[2]

The two viewpoints given in the quotations opening this chapter succinctly reveal the diversity of opinions and the contours of the debates about foreign aid. Foreign aid has always been controversial. As early as 1947 Congressman (later Senator) Everett Dirksen of Illinois labeled the **Marshall Plan**, a post–World War II aid program for European reconstruction now seen as one of the most highly regarded aid programs of all time, as "Operation Rat-Hole." Prominent

[1]Bill Gates, "Staying Committed to Development," *theGatesNotes*, April 11, 2011; www.thegatesnotes.com/Topics/Development/Staying-Committed-to-Development.

[2]Jesse Helms, "Towards a Compassionate Conservative Foreign Policy." Remarks delivered at the American Enterprise Institute, January 11, 2001, available at http://aei.org/speech/foreign-and-defense-policy/towards-a-compassionate-conservative-foreign-policy/.

economists such as Peter Bauer and Nobel laureate Milton Friedman have strongly criticized aid. Bauer believed that aid only enriches elites in recipient countries and famously quipped "aid is a process by which the poor in rich countries subsidize the rich in poor countries."[3] Friedman argued, beginning in the 1950s, that aid only strengthened and enlarged central governments, and as a result, aid did more harm than good. Critics, from both left and right, see aid as a political tool that distorts incentives, invites corruption, and entrenches corrupt dictators and elite business interests. Many believe that aid has little effect on growth and often has done more harm than good for the world's poor. They cite the widespread poverty in Africa and South Asia despite four decades of aid and point to countries that have received significant amounts of aid and have had disastrous growth records, including the Democratic Republic of the Congo (formerly Zaire), Haiti, Papua New Guinea, and Sudan. Critics call for aid programs to be dramatically reformed, substantially curtailed, or eliminated altogether.

By contrast, supporters see foreign aid as an important ingredient in fighting poverty, accelerating economic growth, and achieving other development objectives in low-income countries, especially in the very poorest countries, where people may not be able to generate the resources needed to finance investment or health and education programs. Equally prominent economists, such as Columbia University's Jeffrey Sachs and Nobel laureate Joseph Stiglitz, argue that, although aid has not always worked well, its overall record is positive, and it has been critical for poverty reduction and growth in many countries and helped prevent even worse performance in many others. Advocates argue that many of the weaknesses of aid have more to do with the donors than with the recipients, and because substantial amounts of aid are given for political purposes, it should not be surprising that it has not always been effective in fostering development. They point to a range of successful aid recipients such as Botswana, Korea, Indonesia, and Taiwan, and more recently, Ghana, Mozambique, and Uganda. They also note broader aid-financed initiatives such as the green revolution, the campaign against river blindness, and the introduction of oral rehydration therapy. They note that in the decades since aid became widespread in the 1960s, poverty indicators have fallen in many countries, and health and education indicators have risen faster than during any other 50-year period in human history.

Since its modern origins in the aftermath of World War II, foreign aid has become an important form of international capital flow from the richest to poorest countries

[3]Peter Bauer, *Dissent on Development* (Cambridge: Harvard University Press, 1972). For more recent critiques of aid, see William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* (Cambridge: MIT Press, 2001), and *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (New York: Penguin Press, 2006); Dambisa Moyo, *Dead Aid: Why Aid Is Not Working and How There Is a Better Way for Africa* (New York: Farrar, Straus & Giroux, 2009).

as well as a way to provide technical expertise and donate commodities such as rice, wheat, and fuel. While it plays a much less significant role in middle-income countries, it remains as much a source of debate and controversy there as in other countries. Official development assistance from Organization for Economic Co-Operation and Development (OECD) nations to low- and middle-income countries totaled close to $130 billion in 2010. Aid given to richer countries and aid provided by China, the oil-rich nations, and others add to this total. More than 40 governments around the world provide aid, and 150 countries receive at least some aid inflow. For some countries, the amounts are trivial, amounting to half of a percent of gross national income (GNI) or less. In others aid flows are substantial, totaling 20 percent, 40 percent, or even more of GNI.

This chapter explores the motivations for and impacts of foreign aid. The empirical evidence on aid effectiveness is decidedly mixed, with some research showing little or no relationship between aid and development and others showing a positive impact. On balance, the evidence suggests that on average aid has had a modest positive impact on development outcomes, but with wide variation. Aid has supported growth and development in some countries and contributed to more broad-based improvements in certain areas, such as health and agricultural technology. But, in other countries, it has had little effect and did not spur growth; in some countries, it probably held back the process of development, particularly when donors have given it to political allies with corrupt or ineffective governments that showed little or no interest in economic development.

This mixed record has led to sharp debates. Where, when, and how should aid be provided? Which countries are most likely to use aid effectively? Who should have the major responsibility for designing and implementing aid programs? What kinds of conditions should donors impose on recipients? And how can donors ensure that aid is not wasted and gets to the people who need it most and can use it most effectively?

DONORS AND RECIPIENTS

WHAT IS FOREIGN AID?

Foreign aid consists of financial flows, technical assistance, and commodities given by the residents of one country to the residents of another country for development purposes, either as grants or as subsidized loans. Aid can be given or received by governments, charities, foundations, businesses, or individuals. Not all transfers from wealthy countries to poor countries are considered to be foreign aid (or the equivalent term, **foreign assistance**). It depends on who gives it, what it is given for, and the terms on which it is provided. A commercial loan from Citibank to build an electricity generator is not aid nor is a grant from the British government to purchase military equipment. However, a grant from the British government to build an electricity generator counts as foreign aid.

An official source for definitions, data, and information on foreign aid is the Development Assistance Committee (DAC) of the OECD, an international organization with membership consisting of the governments of over 30 industrialized countries, including almost all the major donors. According to the DAC, to be counted as foreign aid the assistance must meet two criteria:

- It must be designed to promote economic development and welfare as its main objective (thus excluding aid for military or other nondevelopment purposes).
- It must be provided as either a grant or a subsidized loan.

The grants and subsidized loans that make up foreign aid are often referred to as **concessional assistance**, whereas loans that carry market or near-market terms (and therefore are not foreign aid) are categorized as **nonconcessional assistance**.[4] Distinguishing between subsidized and nonsubsidized loans requires a precise definition. According to the DAC, a loan counts as aid if it has a "grant element" of 25 percent or more, meaning that the present value of the loan (taking into account its interest rate and maturity structure) must be at least 25 percent below the present value of a comparable loan at market interest rates (usually assumed by the DAC, rather arbitrarily, to be 10 percent with no grace period). Thus the grant element is zero for a loan carrying a 10 percent interest rate, 100 percent for an outright grant, and something in-between for other loans.

Official development assistance (ODA) is the term used to describe aid provided by DAC donor governments (hence the term *official*) to low- and middle-income countries for development purposes. If a donor provides foreign aid for military purposes—as the United States does for many nations, including Egypt and Israel—this may be included in the U.S. foreign aid budget but is not included as ODA by the OECD. **Private voluntary assistance** is another and growing form of foreign assistance that also is not included in tallies of ODA because it is not official assistance. Private assistance includes grants from NGOs, religious groups, charities, foundations, and private companies. The Bill & Melinda Gates Foundation provides over $1 billion per year to support programs especially in health and education in low-income countries. World Vision, Save the Children, Care, and Oxfam International are NGOs that may be familiar to you. They collect billions of dollars each year from donations by individuals, mostly citizens of rich nations, and spend them on humanitarian and other forms of assistance in poor nations. Some estimates suggest

[4]Nonconcessional loans from donor agencies are counted as part of official development *finance* but not as official development *assistance*.

[5]Homi Kharas, "The New Reality of Aid," in L. Brainard, and D. Chollet, eds., *Global Development 2.0: Can Philanthropists, the Public, and the Poor Make Poverty History*? (Washington, DC: Brookings Institution, 2008).

that private voluntary assistance may amount to as much as one half to two thirds of ODA.[5] This is a dramatic increase from even a few decades ago.

WHO GIVES AID?

Although economic assistance from one country to another has occurred for centuries, today's foreign aid programs trace their origins to the 1940s and the establishment of the United Nations, the World Bank, the International Monetary Fund (IMF), and the Marshall Plan (Box 14-1). Historically, most aid has been given as **bilateral assistance** directly from one country to another. Some of the major bilateral aid agencies today include the U.S. Agency for International Development (USAID), the United Kingdom's Department for International Development (DFID), the Japan International Cooperation Agency (JICA), the Saudi Fund for Development, the Canadian International Development Agency (CIDA), and Swedish International Development Cooperation Agency (SIDA). Some governments have multiple bilateral aid agencies. The U.S. government has well over a dozen departments and agencies that provide bilateral aid, including USAID; the Millennium Challenge

BOX 14-1 THE MARSHALL PLAN

When World War II ended in 1945, world leaders hoped that Europe would not require much outside assistance and that the key economies (especially Britain and France) could quickly rebuild themselves. But by 1947, there had been little progress, and there was growing concern that discontent in Europe could encourage the spread of communism or fascism. U.S. Secretary of State George Marshall proposed a new approach to reconstruction at a commencement address at Harvard University on June 5, 1947, in which the United States would provide substantial amounts of funding, but only if the European nations, for the first time, could work together to draw up rational plans for reconstruction.

Despite some objections by isolationist members of the U.S. Congress, President Truman signed legislation funding the program, officially called the European Recovery Program, in April 1948. By June 1952 (when the program officially ended), the United States had provided $13.3 billion in assistance (equivalent to over $100 billion in today's dollars) to 16 countries in Europe. Almost 90 percent of the funds were provided as grants. The largest recipients in dollar terms were the United Kingdom, France, Italy, Germany, and the Netherlands. For most of the major recipients, funding exceeded 1 percent of gross domestic product (GDP). From the perspective of the United States, these were large commitments representing 1.5 percent of its GDP. The Marshall Plan was seven times larger than current U.S. official development assistance, which in 2010 was 0.21 percent of U.S. GDP.

The Marshall Plan is generally regarded as having been a huge success in helping stimulate rapid growth and recovery in Europe (although some analysts believe that recovery was already under way and would have occurred without the funding). While the Marshall Plan is often held up as a model (Marshall won the Nobel Prize for Peace, in 1953), it differed in many ways from today's aid programs. Most important, it was aimed at countries that already had relatively high incomes, highly skilled workforces, and established financial and legal institutions, characteristics absent from most low-income countries. The Marshall Plan was designed to help relatively advanced countries rebuild infrastructure and rebound to their earlier levels of productive capacity, whereas today's aid programs are aimed at the much more difficult task of initiating growth and development in countries where it (by and large) has yet to occur. Nevertheless, the Marshall Plan and its perceived success provided the foundation for today's aid programs.

Corporation; the Departments of Agriculture, Defense, Health and Human Services, State, and Treasury; and the Peace Corps.

While most bilateral aid is provided to support recipient country governments, some is disbursed to churches, research organizations, universities, private schools and clinics, and nonprofit agencies. Even private companies sometimes receive foreign assistance, such as U.S. assistance through *enterprise funds* that make investments in firms (such as in Poland in the early 1990s) or aid to micro-finance agencies, like the Grameen Bank in Bangladesh, that provide loans to small-scale entrepreneurs. Sometimes aid is provided as cash, but often it is delivered as goods (such as food aid or medicine) or services (such as technical assistance), or in the form of debt relief. An example of the latter is the nearly $5 billion in debt relief Liberia received in 2010 from the World Bank, IMF, African Development Bank, and other creditors. This was a massive sum, equivalent to almost $1,200 for every Liberian. The debt that was taken off the books had been incurred by Liberia's previous governments in the 1970s and 1980s, but 15 years of civil war had destroyed the economy, making repayment by the current government impossible.

In terms of total dollars, the United States has consistently been the world's largest donor, except for a few years in the mid-1990s, when Japan provided the largest amount of aid. In 2009, the United States provided $29 billion in ODA, with France,

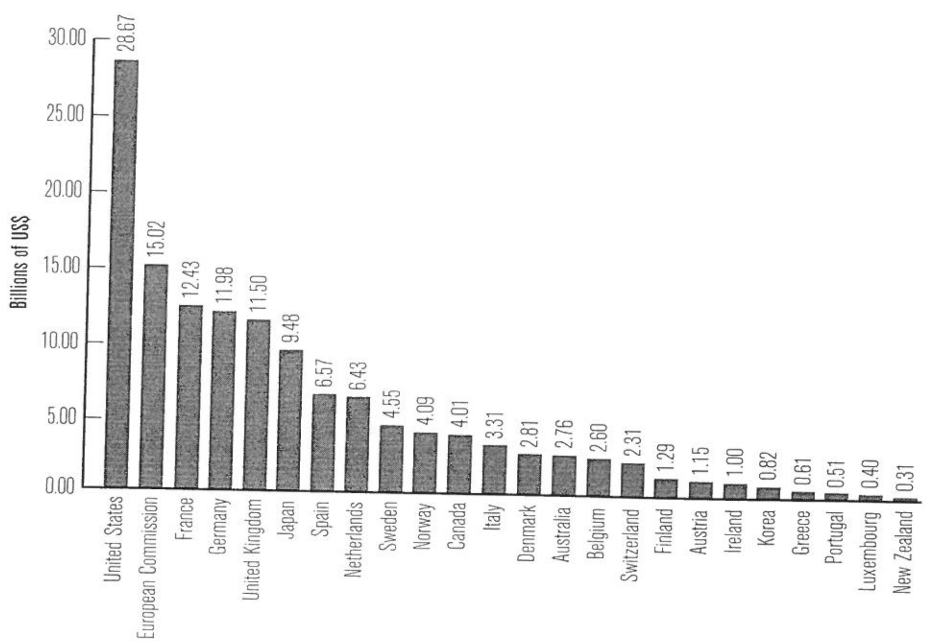


FIGURE 14-1 Net Official Development Assistance, 2009

Source: Organisation for Economic Co-Operation and Development Aid Statistics. Available at http://www.oecd.org/document/49/0,3746,en_2649_34447_46582641_1_1_1_1,00.html.

Germany, and the United Kingdom the next-largest donor countries (Figure 14–1). However, when aid is measured as a share of the donor's income, a different pattern emerges (Figure 14–2). The most generous donors from this perspective are Sweden, Norway, Luxembourg, Denmark, and the Netherlands, each of which provided between 0.82 and 1.12 percent of GNI in ODA in 2009.[6] The United States is one of the smallest donors by this measure, with ODA equivalent to about 0.2 percent of U.S. income. This figure is well below its 1970 level of 0.32 percent and U.S. contributions during the 1960s, when ODA averaged 0.51 percent of U.S. income. Foreign aid makes up less than 1 percent of the U.S. federal budget. This is much smaller than the public believes: Surveys show that Americans think that the United States spends upward of 20 percent of its budget on foreign aid.[7] Although U.S. ODA levels as a

[6]Over the past decade one of the largest donors in the world measured as a share of its income was Saudi Arabia, which provided more than 1 percent of its GNI in aid. Saudi Arabia had been a much smaller donor until it increased assistance to Afghanistan and several other countries in the aftermath of the September 11 terrorist attacks on the United States. It is uncertain whether this trend will continue.

[7]Since 2001, surveys of public opinion in the U.S. consistently find that Americans overestimate the share of government spending devoted to foreign aid. In 2010, World Public Opinion.org asked a random sample of over 800 American adults, "Just based on what you know, please tell me your hunch about what percentage of the federal budget goes to foreign aid." The median response was 25 percent. A follow-up question then asks, "What do you think would be an appropriate percentage of the federal budget to go to foreign aid, if any?" The median response was 10 percent. Survey available at www.worldpublicopinion.org/pipa/pdf/nov10/ForeignAid_Nov10_quaire.pdf; accessed February 2012. Foreign aid is not alone; the public generally overestimates the relative size of most government expenditures.

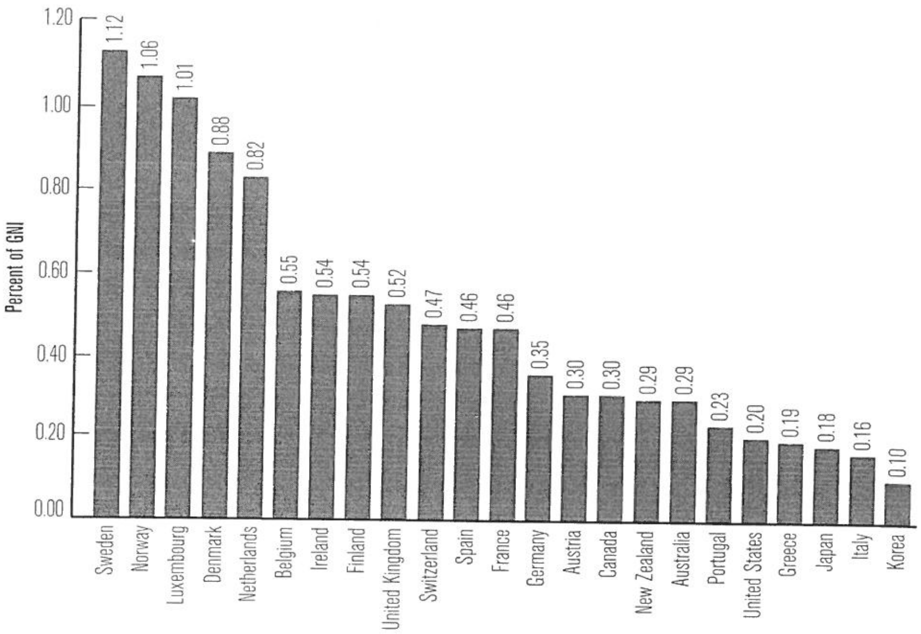


FIGURE 14-2 Net Official Development Assistance As a Percentage of Donor GNI, 2009

GNI, gross national income.

Source: Organisation for Economic Co-Operation and Development, Aid Statistics. Available at http://www.oecd.org/document/49/0,3746,en_2649_34447_46582641_1_1_1_1,00.html.

share of income are small compared to other countries, the United States and other rich countries affect poor countries in many more ways than just foreign aid: Policies on trade, technology, migration, security, and others areas are also important, as described in Box 14-2.

In nominal terms, global ODA increased steadily from the 1960s until it reached a peak of $60 billion in 1991, just after the end of the cold war (Figure 14-3). Aid flows then declined for a decade before rebounding in the early 2000s. They have risen steadily since due to an increased commitment by rich nations to assist poor ones and to the growth in development assistance provided to Iraq and Afghanistan. In real terms, increases in total ODA over the past decade indicate an even sharper rate of increase from earlier trends. Measured as a share of donor income, ODA fell throughout most of the 1980s and especially the 1990s. The 2000s reversed this trend, with ODA as a share of GNI now on a level last achieved during the 1970s. Given the economic problems currently facing many donor nations it is unclear if this trend will continue. Foreign assistance may start to decline in nominal terms and as a percentage of GNI as rich nations cut back on many areas of government spending.

The values in Figures 14-1 and 14-2 include both the amounts that donors give directly as bilateral aid and the amounts they provide indirectly as **multilateral aid**, which pools together resources from many donors. The major multilateral

BOX 14-2 THE COMMITMENT TO DEVELOPMENT INDEX

Rich countries affect poor countries in many ways, including through their policies on foreign aid, trade, migration, military spending, and the environment. Sometimes, these policies help poor countries; sometimes, they hurt. Open-trade policies can help provide markets for poor countries, but tariffs and quotas imposed by rich countries can keep poor countries out and slow their growth and development. To capture these broader channels beyond aid, the Center for Global Development produces an annual Commitment to Development Index that ranks 22 of the world's richest countries on the quality of their policies that affect poor countries in seven areas:

- Foreign aid, both in terms of its quantity (the amount of both government aid and private charitable contributions) and its quality, in terms of how it is given, to whom, and how much is required to be spent in the donor country.
- Trade policies, capturing tariffs, quotas, and subsidies for domestic farmers that impede trade or otherwise disadvantage poor countries trying to compete in rich-country markets.
- Foreign investment policies, including tax rates; programs that provide political risk insurance for investors against coups or other political instability; and other related policies.
- Migration, capturing the extent to which policies ease or hinder migration (particularly of unskilled rather than skilled workers) from poor to rich countries.
- Environmental policies, including greenhouse gas emissions, fishing subsidies, or other actions that lead to environmental degradation in poor countries.
- Security, including financial contributions to peacekeeping operations, naval operations that secure international shipping lanes, and penalties for certain arms exports.
- Technology, including policies that support research and development and protection of intellectual property rights, which enable creation and dissemination of innovations that help poor countries (like vaccines).

In 2010, Sweden came out on top, thanks to its large foreign aid program (relative to the size of its economy) and liberal immigration policies. Denmark ranked 2nd mostly because of its aid program. The United States ranked 11th, scoring relatively well on trade and security policies but poorly on aid programs.

South Korea, a newcomer to the Development Assistance Committee (DAC), ranked at the bottom, with weak scores on aid, environment, and migration and a strong score on technology. Japan, a more established donor, scored 2nd from the bottom with low scores in every category but technology. As with any composite ranking, the Commitment to Development Index is far from perfect, and different assumptions could change the rankings. Its intent, however, is not to be definitive in the rankings but to generate debate and discussion on the many different ways in which rich countries affect poor countries and on how the most important policies can be improved.

Source: David Roodman, a Senior Fellow at the Center for Global Development, is the architect of the index. The 2010 results are available at www.cgdev.org/section/initiatives/_active/cdi, accessed February 2012.

institutions include the World Bank; the IMF; the African, Asian, and Inter-American Development Banks; the United Nations; and the European Commission. The basic rationale for multilateral institutions is that they can provide larger amounts of aid with (presumably) lower bureaucratic costs (because donors do not have to duplicate efforts in each country) and fewer political ties (because funding decisions cannot be driven as easily by the political concerns of a single donor).

The largest multilateral agency is the **World Bank**, which began as the International Bank for Reconstruction and Development (IBRD) after its founding at a conference held in Bretton Woods, New Hampshire, in July 1944. The word *reconstruction* in the IBRD's title describes its first task, which was to help finance the reconstruction of Europe after World War II. The World Bank group today consists of five affiliated institutions operating in over 100 countries: the IBRD, the International Development Association (IDA), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID). Most of the funding provided by the World Bank is *not* foreign aid. The IBRD lends to middle-income countries at market rates. It obtains its funds by borrowing on world capital markets then relends them to member countries at slightly higher rates. Because the IBRD has an excellent credit rating, it is able to borrow and relend to developing countries at cheaper rates than the recipients could obtain on their own in private markets. The IFC lends on commercial terms and takes minority equity positions in private companies. The MIGA provides guarantees to private foreign investors against loss caused by noncommercial (political) risks, and the ICSID helps settle investment disputes between foreign investors and host countries.

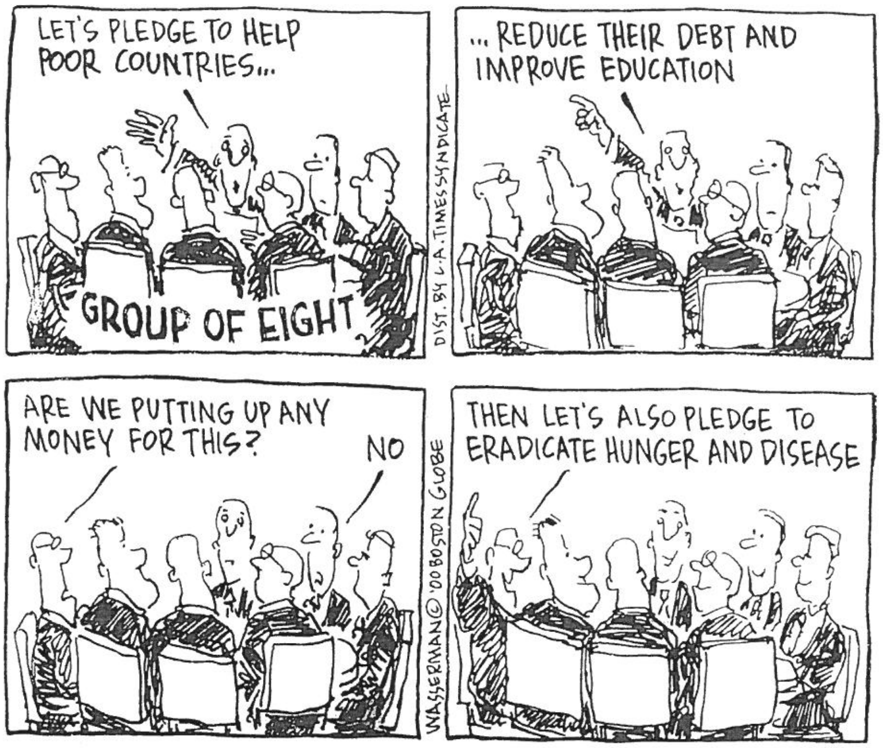
FIGURE 14-3 Global Official Development Assistance, 1975–2008

GNI, gross national income.

Source: World Bank, "World Development Indicators," http://databank.worldbank.org.

The only part of the World Bank that actually provides foreign aid is the IDA. Donor governments contribute funds to the IDA, which uses it to provide highly concessional loans and grants to low-income countries. Funds from the IDA are used for a wide variety of development purposes, including building roads and ports, funding agricultural research and extension, purchasing medicines and schoolbooks, and training government officials. Its standard loan terms include a "service charge" of less than 1 percent per year and a repayment period of between 20 and 40 years, including a 10-year "grace" period during which no repayment is required. To be eligible for IDA funds today, countries must have (2011) GNI per capita of less than $1,165 (although the World Bank makes a few exceptions) and not have access to borrowing on private international capital markets. About 80 countries are eligible to borrow from the IDA. Among the largest borrowers, including countries that are no longer IDA eligible but that were in the past, are India, Vietnam, Tanzania, Ethiopia, and Nigeria. The IDA has disbursed about $222 billion since 1960; annual commitments today average close to $13 billion, 20 percent of which is in the form of outright grants.

The World Bank is owned and controlled by its 187 member governments, with each member having a voting share determined by the size of its shareholding, which



Source: "Group of Eight" cartoon by Dan Wasserman from *The Boston Globe*, January 1, 2000. Copyright © 2000 Boston Globe. All rights reserved. Used by permission and protected by the Copyright Laws of the United States. The printing, copying, redistribution, or retransmission of this Content is prohibited.

in turn is roughly commensurate with its portion of global gross domestic product. The U.S. is the largest shareholder in the IBRD (16 percent). The next-largest shareholders are Japan, Germany, the United Kingdom, and France. China and India each have about 2.7 percent of voting shares in the IBRD. There are on-going calls to reapportion voting rights away from high-income countries to low- and middle-income nations. Some progress has been made in this direction.

The **International Monetary Fund** was also founded at the 1944 Bretton Woods conference.[8] The IMF's original mission was to reestablish an international system of stable national currencies as part of an effort to rejuvenate world trade after World War II. All the IMF's early programs were in today's industrialized countries; frequent lending operations occurred with the United States, the United Kingdom, France, Germany, and other countries until the early 1970s. The IMF played a very

[8]The third organization that was meant to be launched at Bretton Woods was the International Trade Organization (ITO). However, the U.S. Congress failed to pass the legislation necessary to ensure U.S. participation, and the ITO never came into existence. Instead, the international community established the General Agreement on Tariffs and Trade, which was the forerunner of today's World Trade Organization (WTO).

limited role in developing countries until the late 1970s and early 1980s, when many low-income countries began to face severe balance-of-payments problems and debt crises.

Today most of the fund's operations are in low- or middle-income countries. IMF involvement in Greece and Ireland after their financial crises are important exceptions. The IMF's main purpose is to provide temporary financing to countries facing significant balance-of-payments problems stemming from a sharp fall in export prices, a rise in import prices (for example, from an increase in world oil prices), a financial crisis that leads to significant international capital flight, and other shocks. IMF funds are used to shore up the country's foreign exchange reserves and stabilize the currency, *not* to finance investment projects or consumption. The IMF is concerned primarily with helping countries achieve and maintain macroeconomic stability rather than directly supporting economic growth and development (although, of course, a stable environment is important for long-run growth). To receive IMF financing, countries must agree (sometimes controversially) to undertake policy reforms typically aimed at reducing the government budget deficit, tightening monetary policy, increasing the flexibility of the exchange rate, and quickly reducing the current account deficit to restore macroeconomic stability.

The vast majority of the IMF's financing is *not* foreign aid. For its emergency loans (called *stand-by credits*) it typically lends money for a one- to three-year period and charges market interest rates. Only about 10 percent of the IMF's outstanding loans are categorized as ODA, all of it provided to low-income countries. Although IMF programs are designed to be short term, in many instances they are renewed for many years. The IMF had continuous or nearly continuous programs beginning in the 1980s and continuing into the 2000s in Bolivia, Ghana, Malawi, the Philippines, Uganda, and several other countries.

Africa, Asia, and Latin America each have their own **regional development banks**: the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank.[9] Like the World Bank, each of the major regional banks provides financing on both concessional and nonconcessional terms, depending on the income level of the borrower. Regional member countries and the major aid donors contribute to the capital of these banks, which also borrow on private capital markets to finance "hard" (nonconcessional) loans and receive contributions from aid donors for their "soft" (concessional) loan and grant operations. Other multilateral donors include the European Union (EU), the Organization of the Petroleum Exporting Countries (OPEC) Fund, and the Islamic Development Bank.

[9]A fourth, the European Bank for Reconstruction and Development, finances investment in eastern Europe and central Asia, but almost none of its finance is concessional.

The United Nations also has a range of foreign assistance programs that are of a considerably smaller scale than the lending programs of the World Bank or IMF. Much of this assistance comes as technical cooperation (consultants, advisers, and other expertise), primarily from the United Nations Development Programme (UNDP), the United Nations Population Fund (UNFPA), and the World Health Organization (WHO). Other United Nations agencies provide grants for development projects and humanitarian assistance, including the World Food Program (WFP), the United Nations Children's Fund (UNICEF, winner of the 1965 Nobel Prize for Peace), and the United Nations High Commissioner for Refugees (UNHCR).

WHO RECEIVES FOREIGN AID?

According to the DAC, over 150 countries and territories around the world are receiving aid. Table 14–1 shows the largest 10 recipients in 2009, each of which received more than $2 billion. Afghanistan topped the list (remember, ODA *does not* include military assistance). Total dollar amounts are important, but they do not tell the entire story. On a per capita basis, the aid flows to some of these countries are fairly small. Bangladesh received $1.2 billion in ODA, which sounds like a big number, but Bangladesh is a very populous country with over 160 million people. ODA inflows were equivalent to just a few percent of its GNI, or about $7.50 per Bangladeshi, the cost of a few kilograms of rice. But for some recipients with smaller economies, the amounts involved are quite large. Sierra Leone received $450 million in 2009 equal to 24 percent of its GNI that year. For its almost 6 million people, ODA worked out to be about $78 dollars per person, compared to a GNI per capita of $340 in the same year. For other (even smaller) countries a little bit of aid goes even farther. Tuvalu, a middle-income, island nation in the Pacific Ocean with a population of under 10,000 received $17 million in aid in 2009, which translated into 44 percent of GNI and over $1,700 per Tuvaluan. The difference in the apparent magnitudes of aid measured in nominal terms, as a share of GNI and aid per capita, reflects not only the behavior of the donors but the size of the population and income level of the recipient countries. A high aid to GNI ratio can indicate a large amount of aid, but it can also result from a low GNI or small population.

On a regional basis, sub-Saharan African countries received ODA flows averaging 4.9 percent of GNI in 2009, or $53 per person (Table 14–2). Despite the massive numbers of people living in absolute poverty in South Asia, exceeding the levels in sub-Saharan Africa, South Asia received less than 1 percent of its GNI in ODA, about $9 per person. For low-income countries around the world, donors in 2009 provided aid averaging about $47 per recipient, an increase from $14 in 2003. What happened over the those six years? Did the rich nations suddenly triple their commitment to the poorest nations? Not really. Since 2003, India graduated from low- to middle-income status, significantly raising the aid per capita amounts for low-income nations.

TABLE 14-1 Major Official Development Aid Recipients (2009)

RANK	COUNTRY	TOTAL ODA (MILLIONS OF CURRENT US$)
1	Afghanistan	6,235
2	Ethiopia	3,820
3	Vietnam	3,744
4	West Bank and Gaza	3,026
5	Tanzania	2,934
6	Iraq	2,791
7	Pakistan	2,781
8	India	2,502
9	Côte d'Ivoire	2,369
10	Congo, Dem. Rep.	2,354
RANK	**COUNTRY**	**ODA (PERCENT OF GNI)**
1	Liberia	70
2	Afghanistan	45
3	Solomon Islands	44
4	Tuvalu	43
5	Burundi	42
6	Micronesia, Fed. Sts.	41
7	Marshall Islands	32
8	Palau	28
9	Sierra Leone	24
10	Congo, Dem. Rep.	22
RANK	**COUNTRY**	**ODA PER CAPITA (MILLIONS OF CURRENT US$)**
1	Mayotte	2,751
2	Tuvalu	1,785
3	Palau	1,737
4	Marshall Islands	1,101
5	Micronesia, Fed. Sts.	1,093
6	West Bank and Gaza	748
7	Dominica	533
8	Grenada	463
9	Vanuatu	442
10	Kosovo	437

GNI, gross national income; ODA, official development assistance.

Source: World Bank, "World Development Indicators," http://databank.worldbank.org.

Generally speaking, aid is an important type of capital flow for low-income countries, but not most middle-income countries. Aid flows averaged 9.3 percent of GNI in low-income countries in 2009 but just 0.1 percent of GNI in upper-middle-income countries. As discussed in Chapter 10, in the 1990s private capital flows grew sharply in middle-income countries, more than compensating for a fall in aid. In low-income countries, private capital rose much more slowly and remained significantly smaller than aid.

TABLE 14-2 Official Development Aid Receipts by Region and Income, 2009

	MILLIONS OF US$	PERCENT OF GNI	DOLLARS PER PERSON
Sub-Saharan Africa	44,553	4.9	53
South Asia	14,607	0.9	9
East Asia and Pacific	10,276	0.2	5
Europe and central Asia	8,101	0.3	20
Middle East and North Africa	13,589	1.1	42
Latin America and Caribbean	9,104	0.2	16
Low income	36,279	9.3	47
Lower-middle income	40,482	1.1	17
Upper-middle income	13,222	0.1	5
High income	433	0.0	0.4

GNI, gross national income.

Source: World Bank, "World Development Indicators," http://databank.worldbank.org.

THE MOTIVATIONS FOR AID

What determines to whom donors provide aid and how much they give? Donors have a variety of motivations in providing aid, only some of which are directly related to economic development.

FOREIGN POLICY OBJECTIVES AND POLITICAL ALLIANCES There is little question that foreign policy and political relationships are the key determinants of aid flows. During the cold war, both the United States and the Soviet Union used aid to vie for the support of developing countries around the world. The United States provided significant amounts of aid to countries fighting communist insurgencies with little regard as to whether the aid was used for development, including Vietnam in the 1960s; Indonesia, the Philippines, and Zaire in the 1970s and 1980s; and several countries in Central America in the 1980s. The Soviet Union countered with aid to North Korea, Cuba, and countries across Eastern Europe. Both sides vied for support in newly independent countries across Africa and used aid to gain support for crucial votes in the United Nations or other world bodies. The United States and the Soviet Union are not the only countries to have used aid in this kind of competitive way: France, Germany, the United Kingdom, Taiwan, and China have used aid (among other policy tools) to try to gain support and recognition for their governments from countries around the world (Box 14-3).

Many donors provide significant aid to their former colonies as a means of retaining some political influence. Being a former colony substantially increases the probability of receiving aid flows. Between 1970 and 1994, 99.6 percent of Portugal's aid went to former colonies, whereas 78 percent of aid from the United Kingdom and

BOX 14-3 CHINA'S FOREIGN AID

China has had a small foreign aid program since the founding of the People's Republic of China in 1949. During the following three decades, China was a low-income country, with annual foreign exchange earnings of less than $10 billion a year, barely enough for China to pay for essential imports. China became a member of the World Bank in 1980 and became eligible for International Development Association (IDA) loans, with their heavily subsidized interest rates, which were available only to low-income countries. During these early decades, Chinese foreign aid involved small loans and grants mainly to friendly neighbors (North Korea for example) and to countries willing to switch formal diplomatic recognition from the Republic of China on Taiwan to the People's Republic with its capital in Beijing.

This situation began to change in the late 1980s and 1990s and changed dramatically in the first decade of the twenty-first century. China does not report the specific dollar amounts of its total aid to developing countries nor does it give a breakdown of that aid by recipient country. It is also not easy to distinguish between what is development aid in accordance with the official definition of development assistance as used by international organizations, by which the grant proportion of any assistance must be at least 25 percent of the total. Still there is no doubt that China's foreign aid had risen to billions of dollars a year by 2010. Some of this aid was in the form of outright grants, but much of it took the form of heavily subsidized loans from the Export-Import Bank of China. The official position of the Chinese government is that developing countries know best how foreign aid should be used and therefore the government never attaches conditions to its assistance, unlike the World Bank and many bilateral aid agencies that typically require the recipient country to institute particular reforms in order to receive aid.

While officially the purpose of Chinese aid is to provide unconditional funds to low-income countries to help them raise their incomes, the reality is that much of the aid is directed to countries that are important to China's own development. China's rapid industrialization over the past three decades has turned China into one of the world's largest importers of natural resource products, ranging from oil to iron and copper ore and much else. Some of the largest recipients of Chinese foreign aid have been countries in Africa that are exporters of oil or have given China the right in their country to explore for oil (Angola, Equatorial Guinea, Ethiopia, and Sudan among others). Many of these countries have repressive governments, and China often has been criticized for aiding governments that carry out repressive measures against their own people, including in the Darfur region of Sudan.

China's goal is to obtain the rights to develop and import natural resource products from whoever is willing to sell, and ownership and drilling rights are seen as a way of securing reliable sources of these products. Aid in turn helps acquire those rights. The aid finances large infrastructure construction projects, ranging from roads to government buildings and hospitals, often built by Chinese construction companies and with Chinese labor battalions. Many countries use their aid programs to support their own economic and geopolitical interests abroad so China is not unique in this respect.

Sources: State Council of China, "White Paper: China's Foreign Aid" *China Daily*, April 22, 2011; Thomas Lum, Hannah Fischer, Julissa Gomez-Granger, and Anne Leland, "China's Foreign Aid Activities Africa, Latin America, and Southeast Asia," Congressional Research Service, Washington, DC, February 25, 2009; Robert Rotberg, ed., *China into Africa: Trade, Aid and Influence* (Washington, DC: Brookings Institution Press, 2008).

between 50 and 60 percent of aid from Australia, Belgium, and France went to their former colonies.[10]

For the United States, the most important geopolitical concern outside of the cold war has been the Middle East. Since 1980, two of the largest recipients of U.S. foreign aid (which goes beyond ODA) have been Israel and Egypt because the United States provided financial support to back the Camp David peace agreement signed by those two countries in November 1979. More recently, the largest U.S. aid recipients are countries important to key national security interests, such as Afghanistan, Pakistan, and Jordan. Beginning in 2002, Iraq became the largest recipient of U.S. aid (and the largest aid recipient in the world), and its reconstruction is likely to become the largest single foreign aid program ever recorded. Aid commitments to Iraq began to decline in 2009 while increasing amounts of development assistance shifted to Afghanistan.

INCOME LEVELS AND POVERTY Income and poverty are important considerations in aid allocation, at least for some donors, although not as much as is sometimes assumed.[11] For many people in rich countries, the main rationale for aid is to help those in most need in the poorest countries. Income levels and poverty influence both the amount of aid donors provide and the extent of its concessionality. Donors generally provide their most concessional aid to the poorest countries and give fewer

[10]Alberto Alesina and David Dollar, "Who Gives Foreign Aid to Whom and Why?" *Journal of Economic Growth* (March 2000), 33–63.

[11]Alesina and Dollar, "Who Gives Foreign Aid to Whom and Why?," found that income levels were the primary motivation for aid from Denmark, Finland, Norway, and Sweden.

grants and subsidized loans for higher-income countries. Some aid programs are designed explicitly with this objective in mind. The World Bank's IDA program has an income ceiling (as do the concessional windows of the regional development banks). Once countries reach that ceiling, in most cases, they "graduate" from IDA to nonconcessional IBRD loans. Other programs have less formal graduation rules but still tend to provide less aid as incomes grow.

As incomes of the poorest countries rise, the composition of their capital inflows tends to change, with aid flows declining and private capital inflows increasing. Botswana is an example. It received aid flows equivalent to 15 percent of GNI in the early 1970s, when its income averaged less than $800 per capita, but with its average income now over $6,000, ODA amounts to only a few percent of GNI. But Botswana grew rapidly. The transition from high to low aid receipts generally takes many years because most nations do not grow as quickly as Botswana did. One study calculated that, for the most successful countries, the half-life of aid is about 12 years, meaning that aid falls to about 50 percent of its peak level after 12 years and about 25 percent of its peak after 24 years.[12] So, for many of the poorest countries, a rapid transition to private capital flows is unlikely.

COUNTRY SIZE Donors provide much more aid (either as a share of GDP or per person) to smaller countries than to large countries. If donors were concerned strictly with allocating aid to where the largest numbers of poor people live, much more aid would go to China, India, Indonesia, Bangladesh, and Pakistan. However, the very size of some of these countries sometimes daunts donors. They prefer to provide aid to smaller countries, where the difference it makes is more noticeable. Aid of $50 million would be huge in The Gambia, but would not be noticed in India. For political reasons, donors generally want to influence as many countries as possible, which tends to lead to a disproportionate amount of aid going to small countries. A vote in the UN General Assembly counts the same if it is from a small country or a large one, so donors may try to influence as many small countries as possible.

COMMERCIAL TIES Bilateral aid is often designed at least partially to help support the economic interests of certain firms or sectors in the donor country. Multilateral aid is less prone to these pressures, although by no means immune. Many analysts have concluded that commercial ties are an important determinant of Japan's aid. Food donations help support farmers that produce the crops in the United States and European Union. Many donors tie portions of their aid to purchases within the donor

[12] Michael Clemens and Steven Radelet, "The Millennium Challenge Account: How Much Is Too Much, How Long Is Long Enough?" Working Paper No. 23, Center for Global Development, Washington, DC, February 2003.

country. Automobiles, airline tickets, and consulting services financed by U.S. foreign aid, in most cases, must be purchased from U.S. firms. Tying aid has a long history: Much of the machinery and equipment for the Marshall Plan was purchased from U.S. companies, and all of it had to be shipped across the Atlantic on U.S. merchant vessels. Tying aid probably helps strengthen political support for aid programs within donor countries, but it adds to the costs of aid programs and makes them less effective. One study found that tying aid added 15 to 20 percent to its cost, meaning that recipients received less of a benefit from the aid notionally allocated to their country.

DEMOCRACY Historically, donors have provided foreign assistance with little regard to whether recipient country governments were authoritarian or democratic. This was particularly the case during the cold war, but since the breakup of the Soviet Union, donors have tended to increase their aid to countries that have become democracies. More aid has been aimed at strengthening fragile democracies, supporting the transition of nondemocracies to democracies, or building democratic institutions, including financing for parliaments, election monitoring systems, and groups supporting civil rights and free speech. Alberto Alesina and David Dollar, in a study covering the years 1970 through 1994, found that the typical country received a 50 percent increase in aid after switching to become a democracy.

AID, GROWTH, AND DEVELOPMENT

Many people think of foreign aid primarily as either building infrastructure (such as roads or dams) or providing emergency humanitarian relief after natural disasters, but its purposes often are more diverse. Most foreign aid is designed to meet one or more of four broad economic and development objectives:

- To stimulate economic growth through building infrastructure, supporting productive sectors such as agriculture, or bringing new ideas and technologies.
- To promote other development objectives, such as strengthening education, health, environmental, or political systems.
- To support subsistence consumption of food and other commodities, especially in emergency situations after natural disasters or humanitarian crises.
- To help stabilize an economy after economic shocks.

The extent to which aid has been successful in helping achieve these objectives is a matter of continued debate and controversy.

Despite these broader objectives for aid, economic growth has always been the main yardstick used to judge aid's effectiveness, with more aid expected to lead to

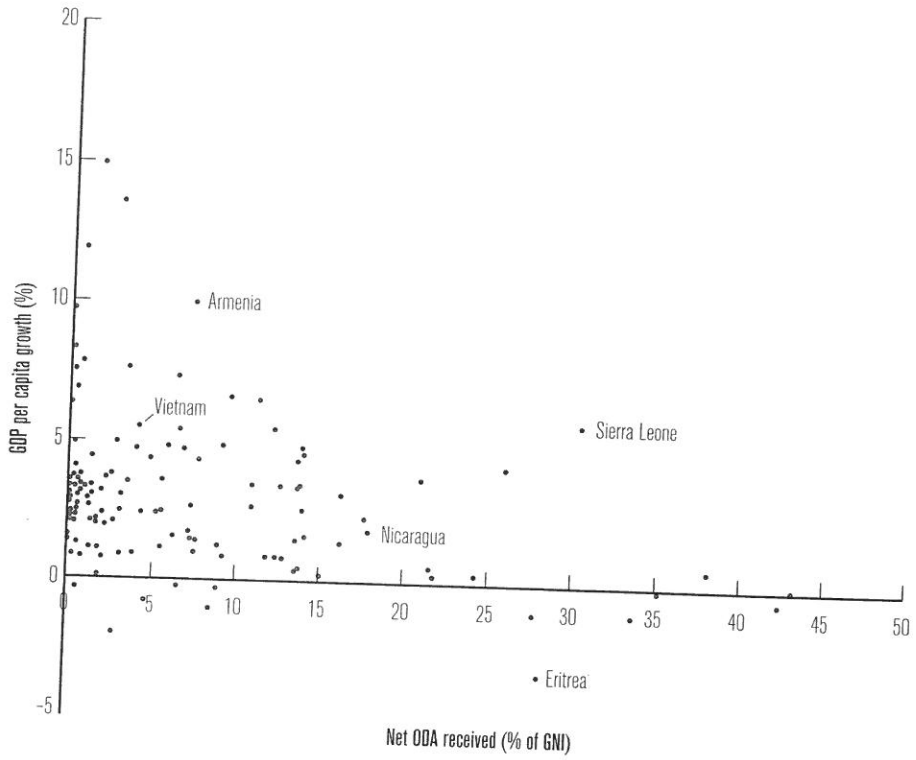


FIGURE 14-4 Foreign Aid and Growth, 1999–2008

GNI, gross national income; ODA, official development assistance.

Source: World Bank, "World Development Indicators," http://databank.worldbank.org.

faster growth. But, at a very broad level, there is no apparent simple relationship between aid and growth, as shown in Figure 14–4. Some countries that received large amounts of aid recorded rapid growth (Sierra Leone), whereas others recorded slow or even negative growth (Eritrea). At the same time, some countries that received very little aid did very well, whereas others did not (note the scatter of points in Figure 14–4 close to the *y*-axis.)

What does the absence of a simple relationship mean? For some analysts, it is evidence of a failure of aid to achieve its basic objectives. But for others, this simple correlation is misleading because other factors affect both aid and growth. Some countries that received large amounts of aid may face endemic disease or poor geography or may be emerging from long-standing civil conflict, in which case aid might have a positive impact on growth even if the overall growth performance remains weak. Or the causality could run in the opposite direction: Donors give more aid to countries with slow growth rates and much less to rapid growers like China. These analysts suggest that, once these other factors are taken into consideration, a positive relationship emerges. Still others conclude that aid works well under certain circumstances but fails in others. Aid might help spur growth in countries with reasonably good economic policies but fail to do so where corruption is rife and the economy is badly mismanaged. In this view, while the overall trend line is important, the variance around the trend and the reasons for that variance are also critical in understanding the true underlying relationships.

Debate on these issues has been ongoing for many years, and continues today. There is general agreement on some broad issues. Even aid pessimists (at least most of them) agree that aid has been successful in some countries (such as in Botswana or Indonesia or more recently in Mozambique and Tanzania), that aid has helped improve health by supplying essential medicines, and that aid is an important vehicle in providing emergency relief after natural disasters. Similarly, aid optimists concede that much aid has been wasted or stolen, such as by the Marcos regime in the Philippines and the Duvalier regime in Haiti, and that, even under the best circumstances, aid can have adverse incentives on economic activity. Debate continues on the overall general trends, the conditions under which aid works or does not work, and on what steps can be taken to make aid more effective. Empirical evidence is mixed, with different studies reaching different conclusions depending on the time frame, countries involved, and assumptions underlying the research. We summarize these by looking at three views on aid and growth.

VIEW 1. ALTHOUGH NOT ALWAYS SUCCESSFUL, ON AVERAGE, AID HAS A POSITIVE IMPACT ON ECONOMIC GROWTH AND DEVELOPMENT

The clearest economic rationale for aid is to promote growth by financing new investment, especially investment in public goods. Aid used to build roads, ports, electricity generators, schools, and other infrastructure augments the process of capital accumulation, which (if the investments are productive) should accelerate the rate of growth. This motivation for aid has been invoked since the Marshall Plan. Indeed, early analyses of foreign aid, such as Walt Rostow's popular 1960 book *The Stages of Economic Growth,* saw aid wholly in terms of financing investment and adding to the capital stock.[13] This idea is fully consistent with the Harrod-Domar model, which views capital formation as the main driver of growth, as well as with the Solow model, which sees capital accumulation as important for growth, albeit with diminishing returns and with a strong role for new technology. In the context of these models, aid adds to the total amount of saving, which increases investment and the capital stock, which in turn accelerates the rate of economic growth.[14]

[13]W. W. Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto* (Cambridge: Cambridge University Press, 1960).

[14]As discussed in Chapter 4, in the Harrod-Domar model the effect is a permanent increase in the growth rate; in the Solow model it is a transitory increase in the growth rate until the economy achieves a new steady level of output.

In this view, poor countries are unable to generate sufficient amounts of saving on their own to finance the investment necessary to initiate growth, or if they do they can finance only very slow growth. As discussed in Chapter 10, saving rates tend to be low in the very poorest countries, and even where they are moderately high, the actual amount of saving is low. A country with per capita income of $200 and a saving rate of 10 percent generates saving of $20 per person per year, which cannot purchase much in terms of capital goods. In the strongest version of this view, the poorest countries may be stuck in a **poverty trap**, in which their income is too low to generate the saving necessary to initiate the process of sustained growth.[15] Total saving may be too small to compensate for depreciation, let alone add to the capital stock. In a more moderate version, the poorest countries may be able to save enough to begin to grow, but only at very slow rates. Thus aid flows provide a way to augment domestic saving and accelerate the growth process.

Aid can also support growth by building knowledge and transferring new ideas, technology, and best practices from one country to another. Some aid helps support research in low-income countries that can accelerate the pace of growth. One of the best examples is aid-funded research in the 1960s and 1970s on new varieties of seeds, fertilizers, and pesticides that helped transform agriculture in Asia through what became known as the *green revolution*. Similarly, a significant portion of aid finances advisers and technical assistance that ultimately is aimed at strengthening institutions and increasing productivity. This kind of aid, when it is effective, can be thought of as shifting the production function upward, thereby helping increase the rate of growth.[16]

The majority of studies, although far from all, find a positive relationship between aid and growth, on average, after controlling for the impact of other factors on growth.[17] In particular, beginning in the mid-1990s researchers began to investigate whether aid might spur growth, albeit with diminishing returns—that is, small amounts of aid might have a relatively large impact on growth, but each additional dollar of aid might have less effect. This may seem like an obvious point because it is the standard assumption about capital accumulation in most growth models (such as the Solow model), but it is surprising that earlier research tested only a linear relationship. Many (but not all) of the studies that allow for diminishing returns and control for other variables find a positive relationship, on average, between total aid

[15]See Jeffrey Sachs et al., "Ending Africa's Poverty Trap," *Brookings Papers on Economic Activity 1* (2004), 117–240.

[16]In the Solow model, the increase in the rate of growth lasts only during the transition to a new steady-state level of income.

[17]For a recent review of the research, see Michael Clemens, Steven Radelet, Rikhil Bhavnani, and Samuel Bazzi, "Counting Chickens When They Hatch: Timing and the Effects of Aid on Growth," *Economic Journal*. Published electronically December 1, 2011. http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0297.2011.02482.x/full.

and growth.[18] In terms of Figure 14–4, these studies find that other variables, such as geography, political conflict, policies, and institutions explain much of the variance in growth rates among aid recipients. They conclude that, after controlling for these variables and allowing for diminishing returns, a positive relationship between aid and growth emerges, albeit with important variance around the trend line. This view is captured by Figure 14–5a. But as we shall see, other research reached different conclusions, so the debate about the relationship between aid and growth remains open.

In addition, for defenders of View 1, aid can have a positive impact on other important development objectives that may affect growth only indirectly or affect it only after a long period of time, such as health, education, or the environment. Similarly, it can provide emergency assistance or humanitarian relief or be used to help achieve macroeconomic stability. We briefly review each of these in turn.

PROMOTING HEALTH, EDUCATION, AND THE ENVIRONMENT Nearly half of all aid flows are aimed at improving health, education, the environment, and other objectives. Aid that finances immunizations, medical supplies, medicines, bed nets (to prevent the spread of malaria), clean water, and school supplies is meant to help provide essential goods and services to people too poor to afford them. In economic terms, most of these kinds of expenditures count as additions to consumption rather than investment (although some aid for education and health, such as building schools and clinics, count as investment).

Economic growth is often a secondary, long-term objective of this kind of aid. Healthier, better-educated workers should be more productive, shifting the production function and expanding output and income. A similar argument can be made for at least some aid aimed at protecting the environment. Improving forest or fisheries management, cleaning water supplies, or reducing air pollution can improve welfare and increase productivity over time. The impact on growth, however, can take a long time to materialize. Programs to immunize children or improve the quality of primary schools do not affect labor productivity until these children join the workforce, which is many years after the aid was received.

Research on the relationship between aid and other development outcomes tends to concentrate on evaluating specific projects and interventions rather than broad cross-country trends. As with growth, in many cases, aid appears to have had

[18]Cross-country econometric studies that allow for diminishing returns typically do so by including both aid and aid squared as determinants of growth. This specification yields a parabola in which aid has a positive effect on growth with diminishing returns, but in theory, with enough aid, the marginal impact could be negative. However, in these studies, the data points are concentrated on the upward portion of the curve, so they do not conclude that large amounts of aid have a negative impact. See, for example, Carl-Johan Dalgaard, Henrik Hansen, and Finn Tarp, "On the Empirics of Foreign Aid and Growth," *Economic Journal* 114, no. 496 (2004), 191–216; Robert Lensink and Howard White, "Are There Negative Returns to Aid?" *Journal of Development Studies* 37, no. 6 (2001), 42–65; Henrik Hansen, and Finn Tarp, "Aid and Growth Regressions," *Journal of Development Economics* 64 (2001), 547–70.

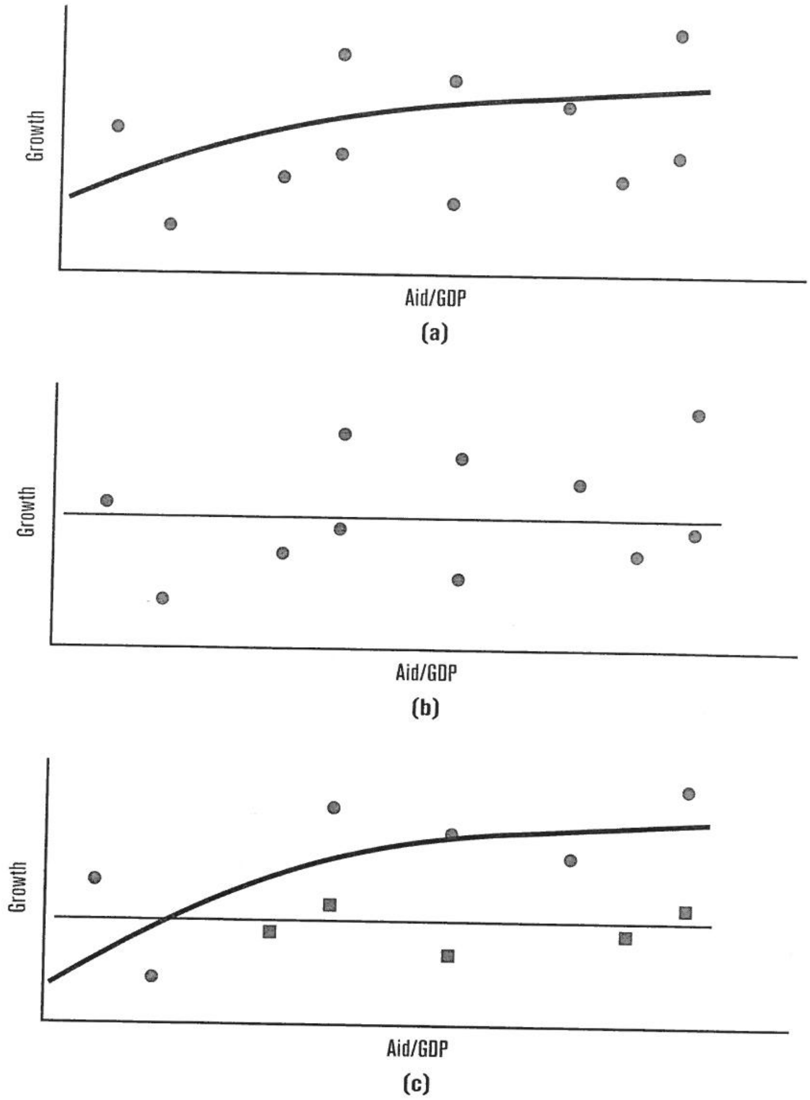


FIGURE 14-5 Three Views on Aid and Growth

(a) View 1: Aid has a positive impact on growth with diminishing returns after controlling for the impact of other variables. (b) View 2: Aid has little or no impact on growth and may have a negative impact. (c) View 3: Aid has a positive impact on growth in some circumstances (circles) but no impact in others (squares).

GDP, gross domestic product.

a strong impact on health and education, along with many interventions that failed. Perhaps the best documented are aid-financed interventions in health. A group of experts convened by the Center for Global Development documented 17 cases of large health interventions in developing countries that have been very successful in improving health outcomes and saving lives, several of which are discussed in

Chapter 9 and in Box 14–4.[19] A massive global effort spearheaded by the World Health Organization succeeded in completely eradicating smallpox from the world in 1977, perhaps the greatest public health achievement ever. A worldwide effort to fight polio, supported by both government aid agencies and private donors such as Rotary International, succeeded in nearly eliminating the disease. The introduction of oral rehyrdration therapy has saved millions of lives after being developed first in East Pakistan (now Bangladesh) in the 1970s. In Egypt, a donor-funded oral rehydration program helped reduce infant diarrheal deaths by an astonishing 82 percent between 1982 and 1987.

BOX 14–4 CONTROLLING RIVER BLINDNESS IN SUB-SAHARAN AFRICA

Onchocerciasis, or river blindness, is a pernicious, parasitic disease that afflicts approximately 18 million people worldwide, with well over 99 percent of its victims in sub-Saharan Africa. Spread through the bite of an infected blackfly living near fast-moving waters, river blindness causes symptoms such as disabling itching, rashes, muscle pain, skin lesions, and in its most severe cases, blindness.

In 1974, governments and donors in 11 West African countries jointly launched the Onchocerciasis Control Programme. At the time, 2.5 million of the area's 30 million inhabitants were infected with the disease, and approximately 100,000 were blind. The primary intervention was weekly aerial spraying of larvicide during rainy seasons along the region's waterways to control the disease-spreading blackflies. The aerial spraying, augmented by hand spraying of breeding grounds, persisted even through civil and regional conflicts and coups. In 1987, the program began distributing the drug ivermectin, which treats the disease's symptoms with a single annual dose.

The program was implemented through unusual cooperation between several governments and a wide range of donors. It was launched under the leadership of the World Health Organization, the World Bank, the Food and Agriculture Organization, and the United Nations Development Programme. A total of 22 donor countries contributed $560 million to support the 28-year project, with much of the financing provided through long-term commitments. The pharmaceutical company Merck & Co. donated ivermectin to the program beginning in 1987, pledging to provide it to anyone that needed it as long as they needed it, making the donation program one of the largest public—private partnerships ever

[19]Ruth Levine with Molly Kinder, *Millions Saved: Proven Success in Global Health* (Washington, DC: Center for Global Development, 2004).

created. Governments and nongovernmental organizations in the recipient countries were critical to implementing the program effectively.

The program achieved impressive success between 1974 and its conclusion in 2002: Transmission was halted completely in all 11 West African countries involved, 600,000 cases of blindness were prevented, and 18 million children born in the program area are now free from the risk of the disease. In addition to the striking health benefits, the economic impact has been impressive. An estimated 25 million hectares of arable land, enough to feed 17 million people, are now safe for resettlement. In Burkina Faso, 15 percent of the country's land that had been deserted because of onchocerciasis has been completely reclaimed, and its new residents now enjoy a thriving agricultural economy.

The program was extremely cost-effective, with a yearly cost of less than $1 per protected person. The World Bank calculated that the annual return on investment (attributable mainly to increased agricultural output) to be 20 percent, and it is estimated that $3.7 billion will be generated from improved labor and agricultural productivity.

Source: Ruth Levine with Molly Kinder, *Millions Saved: Proven Success in Global Health* (Washington, DC: Center for Global Development, 2004), chap. 6.

There have also been several successful education initiatives.[20] A girls' primary school education initiative in Balochistanm, Pakistan, led to a tripling of the number of schools, a more than doubling of girls' enrollment, and an increase in the girls' primary school completion rate from 7 to 30 percent between 1990 and 1998. In Ethiopia, a systemwide set of education reforms implemented in the 1990s with the support of USAID, the World Bank, and UNICEF led to the construction of many new schools, increasing the number of teachers and improving their training, and expanding the availability of textbooks. Between 1991 and 2001, the overall primary school enrollment ratio increased from 20 to 57 percent, and the girls' enrollment ratio jumped from 12 to 47 percent. In Indonesia, donors partially supported the construction of over 61,000 primary schools in the mid-1970s, which Massachusetts Institute of Technology (MIT) economist Esther Duflo showed led to significant increases in educational attainment and increased wages for school graduates.[21]

[20]For a summary of successful education interventions, see Maria Beatriz Orlando, "Success Stories in Policy Interventions towards High Quality Universal Primary Education" (Washington, DC: Center for Global Development, 2004).

[21]Esther Duflo, "Schooling and Labor Market Consequences of School Construction in Indonesia: Evidence from an Unusual Policy Experiment" *American Economic Review* 91 (September 2001).

These individual success stories only tell part of the story. There also have been many failures, where donors provided funding for health and education reforms that did not happen, for technical assistance that did not help, or for interventions that led to little change in health or education. But beyond case studies, little systematic evidence has been gathered on the circumstances under which aid-financed interventions in health and education have been successful and where they have not.

PROVIDING EMERGENCY ASSISTANCE AND HUMANITARIAN RELIEF About one tenth of all foreign aid provides emergency relief after natural disasters or humanitarian crises. Relief programs after earthquakes, floods, or other disasters typically provide food, clothing, basic medicines and drugs, and other items to help meet subsistence needs. Similarly, humanitarian aid assists people living in refugee camps and those displaced by war or other conflict. From an economic point of view, most of this aid is meant to support basic consumption rather than investment and growth, although some of it is used to rebuild ruined infrastructure and help output from collapsing further than it otherwise might following disasters.

SUPPORTING ECONOMIC AND POLITICAL STABILITY Some aid is provided to help countries facing macroeconomic instability. A fall in export prices, a rise in import prices, or an economic shock, such as a drought, flood, or earthquake, can lead to a sharp depreciation of the exchange rate, which in turn can ripple through the economy and increase the prices of traded goods and services. Aid inflows add to the supply of foreign exchange and can help moderate the pressure on the exchange rate. The IMF plays the leading role in this area, with other donors such as the World Bank providing supporting funds. Aid flows that are a response to a macroeconomic crisis or a natural disaster, as described in the previous paragraph, are inversely correlated with economic growth. Growth falls because of the crisis, and aid increases as a result. These situations account for some of the "below-the-line" cases in Figure 14–4, where aid is associated with very low or even negative GDP growth. But because aid is responding to the low growth, these cases should not be seen as examples of a failure of aid to promote growth and development.

VIEW 2. AID HAS LITTLE OR NO EFFECT ON GROWTH AND ACTUALLY MAY UNDERMINE GROWTH

How could aid have no impact or a negative impact on growth, as suggested by Figure 14–5b? One simple way is if most of it simply is wasted. If donors build large bureaucracies or spend the money on expensive technical experts from their home country that write reports no one reads, aid will not help growth. Aid that winds up in the personal off-shore bank accounts of government officials or finances a fleet of expensive cars for members of parliament creates little stimulus to growth. If aid builds a road but provides no funds for maintenance, there may be an initial burst of output, but this could be followed by a decline back to previous levels as the road deteriorates. Because donors typically like to finance capital costs of new projects but not maintenance, this is a common problem.

More insidious, if aid breeds corruption, government officials and their cronies spend their time plotting about how to siphon aid money to their own bank accounts rather than increasing output. Aid funds used to pay private contractors for construction projects or delivery of services can create opportunities for kickbacks and other illegal activities, just like any other public funds. One of the strongest critiques of aid and how it might undermine development is that it can prop up malevolent dictators and support political regimes that further impoverish rather than help the poor. U.S. aid to the Marcos regime in the Philippines during the 1970s and 1980s, for example, may have helped support an anticommunist ally but probably also lengthened the time in which his corrupt regime remained in power. The same argument can be made about aid in the 1970s and 1980s to the Central African Republic, Haiti, or Zaire.

But even if aid is not simply wasted or misused, it could have a smaller than expected impact on growth because of diminishing returns to investment as the recipient begins to reach its **absorptive capacity**. Government bureaucracies with relatively few skilled workers might have difficulty overseeing and managing larger and larger aid flows. Purchases of commodities and supplies might strain available warehouses or delivery systems. Large donations of medicines might sit unused because they cannot be delivered on time to clinics. In the long run, an increase in aid flows may help expand absorptive capacity because it can be used to train and hire more workers, expand warehouse facilities, or build infrastructure to ease bottlenecks, but in the meantime, the impact of aid may be diminished by these constraints.

Perhaps the most important way in which aid could slow growth is by undermining incentives for private sector activity. Large aid flows can spur inflation and cause a real appreciation of the exchange rate, which reduces the profitability of production of all tradable goods. Aid flows can enlarge the size of the government and related services supporting aid projects, drawing workers and investment away from other productive activities such as agro-processing, garments, or footwear exports, which have been important engines for growth in many countries. These "Dutch disease" effects are usually associated with revenues from natural resource export booms (Chapter 18), but can result from aid flows as well. Some analysts believe that large aid flows to Ghana in the late 1980s and early 1990s undermined export incentives.[22] Similarly, food aid can sometimes undermine local food production, as discussed in Box 14-5.

[22]See Stephen Younger, "Aid and the Dutch Disease: Macroeconomic Management When Everybody Loves You," *World Development* 20, no. 11 (November 1992), 1587–97.

BOX 14-5 FOOD AID AND FOOD PRODUCTION

For many people, it seems obvious that donating food is a good way for rich countries to help poor countries. Although sometimes that is true, under certain circumstances, donations of food can hurt local farmers by undermining the incentives for them to produce food. If all food is produced locally (that is, there are no imports), then an increase in food from aid donations can shift out the supply curve for food and drive down food prices, benefiting consumers but hurting farmers, as shown in Figure 14–6a. In an economy with no commercial imports, food aid shifts the supply curve for food from S_1 to S_2, causing the price to fall from P_0 to P_1. Producers react by reducing output from Q_0 to Q_1, whereas consumers increase consumption from Q_0 to Q_2, with food aid of $Q_2 - Q_1$ filling the gap. Consumers are clearly better off (important if there is a true food shortage) while producers are worse off.

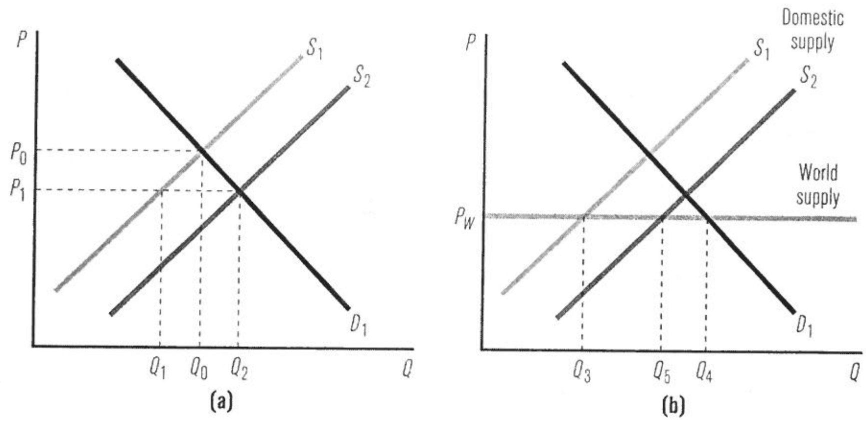


FIGURE 14-6 Food Aid, Prices, and Production

(a) Food aid and production in the absence of imports: Food aid lowers prices, benefiting consumers but displacing local production. (b) Food aid and production with imports: Food aid adds to the total supply without affecting prices or displacing production.

In an economy that produces some food but imports on the margin, the outcome is different, as shown in Figure 14-6b. With a world price of P_w, initial production takes place at Q_3 with consumption at Q_4 and imports of $Q_4 - Q_3$. In this situation, food aid displaces imports, with imports falling to $Q_4 - Q_5$ and food aid making up the difference $Q_5 - Q_3$. Domestic prices, food production, and consumption do not change, with food aid, in effect, saving the economy the cost of the displaced imported food.

AID, SAVING, AND TAX REVENUE Aid could also have a smaller-than-expected effect on growth if it has an adverse impact on saving and investment. Early analysts assumed that, because aid is a form of foreign saving, each dollar of aid would add one full dollar to investment. But this is unlikely to happen, for at least two reasons. First, as mentioned previously, not all aid is provided as investment goods or even aimed at increasing investment and growth. Second, even where aid is aimed directly at investment, the impact could be partially offset by a reduction in either private saving (through a decline in the rate of return on private investment) or government saving (through a fall in tax revenues). If a country that currently invests \$100 million per year receives \$10 million in new aid for investment (for example, building roads), it is highly unlikely that total investment will reach \$110 million. It is far more likely that, with \$10 million in new investment, some of the original \$100 million will be shifted into consumption.

The impact of aid on saving is illustrated in Figure 14–7. Before the recipient country obtains aid, it can produce consumption goods and capital goods along the production possibilities frontier *P*. To simplify, the diagram ignores international trade and other capital inflows, so that consumption initially also must take place somewhere along the production frontier. Community tastes are defined by a set of indifference curves, of which two are shown (labeled *I* and *II*). The country's welfare is maximized if it produces and consumes at point *A*, where the indifference curve *I* is tangent to the frontier *P*, with consumption at C_1 and investment (and saving) at I_1.

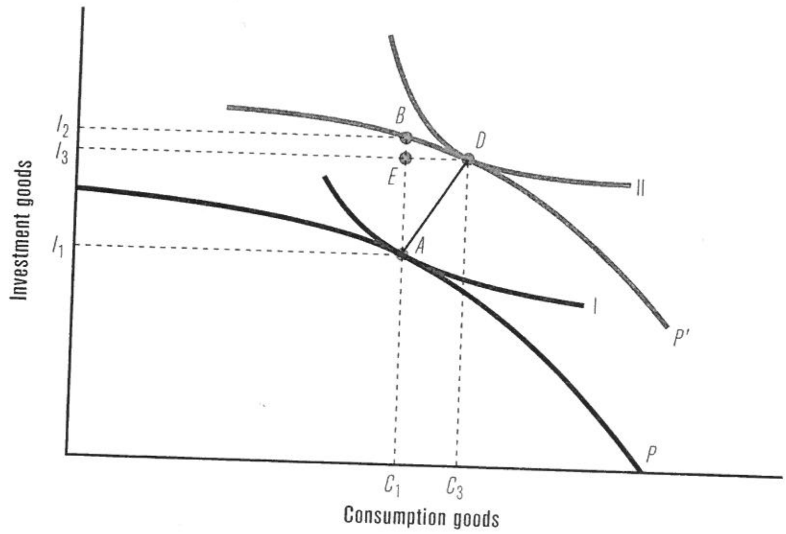


FIGURE 14–7 Impact of Aid on Investment and Consumption

Foreign aid totaling *AB* turns into actual new investment of only *AE* because the country maximizes welfare on the new frontier, *P'*, at point *D*, not *B*. *P'* is not really a production frontier but a supply frontier.

Source: Adapted from Paul Mosley, "Aid, Savings and Growth Revisited," *Oxford Bulletin of Economics and Statistics* 42 (May 1980), 79–91.

Now donor countries contribute an amount *AB* of aid with the intention that it be used to raise investment to I_2. However, the aid moves the *consumption frontier* outward from *P* to *P′*. Now, the country maximizes its welfare at point *D*, the tangency between *P′* and indifference curve I_2, where it consumes C_3 and invests I_3. Of the aid amount *AB*, *AE* (equal to $I_3 - I_1$) is invested and "BE" (equal to $I_2 - I_3$) is consumed. Even if all the new aid money is invested as intended, some of what the country had invested before is shifted to consumption, so in effect, the aid finances an increase in both investment and consumption, with the precise impact depending on production possibilities, community tastes, and other variables left out of the figure, such as trade. Aid may finance mostly investment if $I_3 - I_1$ is a large percentage of total aid (*AB*), or it may mostly finance consumption if $I_3 - I_1$ is a small percentage of *AB*.

Why would the country react in this way and not invest all the aid it receives? Saving always requires a sacrifice of current consumption, based on the anticipation that investment will lead to increased output and greater consumption in the future. When the country receives a new inflow of aid, investment increases and the country is less willing to sacrifice that last dollar of today's consumption to finance the last dollar of investment. Thus domestic saving falls somewhat, although with the addition of foreign saving from aid total saving (and investment) rises.

When substitutions of these kinds are possible and aid effectively finances activities for which it was not originally intended, aid is said to be **fungible**. This kind of substitution could be good or bad, depending how the money is spent. If donor funds to build a school allow members of the community to save less and purchase more food, clothing, and medicine for their families, few donors would take issue. But if instead the freed-up funds are used to buy several Mercedes Benzes for the mayor and his or her staff, donors are likely to be unhappy and economic development is not served.

Aid given as a cash transfer to the budget or as program aid rather than for a specific project deliberately gives the recipient the kinds of choices demonstrated in Figure 14–7. But even if all aid is used for very specific investment projects and the donor audits projects to confirm that the money was spent as planned, substitution is possible. Project aid might be used, for example, for investment projects that the government would have made without aid. In that case, the government's resources are freed up for other purposes. If the government is intending to build an electricity generator with its own funds, then a donor decides to provide the funding, the government's money is freed up for any purpose the government wishes. Even if aid finances projects the government was not planning to implement, the government might simply cut back on other projects because it wants to raise the share of consumption for economic or political reasons.

The tendency for aid flows to "stick" as increased government expenditures, rather than result in tax relief or offsetting expenditure reductions in other areas, is sometimes called the *flypaper effect*. Several studies find that \$1 in aid translates to less than \$1 in government spending, typically in the range of 33 to 67 cents on the dollar. But some studies for specific countries find a strong flypaper effect, with \$1 of aid translating into close to $1 of new spending. One study on Indonesia found that $1 in aid led to $1.50 in government expenditures, suggesting that aid "crowded in" government spending, perhaps by relieving constraints that were limiting government spending.[23]

Aid flows can similarly influence government revenues. A government that receives aid flows is likely to be less willing to raise marginal tax revenue from the general public, especially because taxes are not politically popular. A government without aid inflows might be willing to raise taxes to finance a new hospital, but if a donor finances the hospital, the government has much less incentive to raise the revenue. However, aid could help increase revenues if donors require governments to provide matching funds for a particular activity; if aid helped governments introduce institutional changes to strengthen the tax authority, or in the case of loans, governments knew they would need revenues in the future to repay the loans. The empirical evidence on this effect is mixed: In some countries, aid inflows corresponded with increased revenues, whereas in other cases, revenues declined.[24] Where revenues declined, the reduction may benefit ordinary citizens, who can save and consume more for their own purposes, which could help accelerate economic growth. Or it may be directed to individuals or businesses with special connections to the government.

Private saving might also be affected by aid inflows. A host of subtle influences from aid on relative prices may contribute to substitution that reduces private saving and crowds out private sector investment. Aid inflows could reduce interest rates, which in turn could reduce private saving. If investment is subject to diminishing returns, more capital in general could mean lower returns on investments and hence a greater tendency to consume rather than save in the recipient countries.

It is difficult, if not impossible, for donors to stop this substitution, although they may be able to limit it to some extent. Research suggests that aid funds are fungible, at least partially, meaning that recipients, to some extent, can substitute aid funds from their intended purpose to something else. However, the evidence suggests that aid is not perfectly fungible: Much of it goes to its intended purpose, and recipients cannot or do not transform all aid flows into other purposes.

AID DEPENDENCY Some analysts argue that aid loses some of its effectiveness when aid flows are relatively large for long periods of time, because prices, institutions, and expectations adjust to that level and, to some extent, recipients become

[23]See World Bank, *Assessing Aid: What Works, What Doesn't, and Why* (New York: Oxford University Press, 1998); Tarhan Feyzioglu, Vinaya Swaroop, and Min Zhu, "A Panel Data Analysis of the Fungibility of Foreign Aid," *World Bank Economic Review* 12, no. 1 (1998). For the study on Indonesia, see Howard Pack and Janet Rothenberg Pack, "Is Foreign Aid Fungible? The Case of Indonesia," *Economic Journal* 100 (March 1990).

[24]Mark McGillvary and Oliver Morrisey, "A Review of the Evidence on the Fiscal Effects of Aid," Research Paper no. 01/13 Center for Research in Economic Development and International Trade, Nottingham, UK, 2001. For a classic model on these effects, see Peter Heller, "A Model of Public Fiscal Behavior in Developing Countries: Aid, Investment, and Taxation," *American Economic Review* 65 (1975), 429–45.

dependent on aid. This situation can raise several challenges. First, the larger the amount of aid, the greater is the risk of a sudden reduction in aid. Aid flows tend to be more erratic than domestic revenues, and the degree of volatility increases with greater dependence on aid.[25] If donors suddenly reduce aid, whether because they face budget cutbacks, in response to a corruption scandal, a change in government, or for some other reason, the macroeconomic consequences can be difficult to manage. Second, large aid flows give donors substantial leverage over the recipient, so that recipients become more willing to introduce whatever conditions the donors require, good or bad, to ensure that the aid continues to be disbursed. Aid flows thus can weaken public accountability and impede the development of civil society, if the recipient government becomes more responsive to the donors than to its own citizens.

As recipients become more dependent on aid, the process of gradually reducing aid over time as development proceeds becomes more difficult. If aid finances public expenditure, a reduction of aid must be matched with either an increase in revenue or a reduction in expenditure, neither of which is particularly easy or politically popular (although raising revenue is made easier by the process of economic growth). The incentives are strong for recipients to continue to request aid for as long as possible and resist these adjustments. Egypt has been one of the world's largest aid recipients since 1980, and some observers believe that these inflows have taken the pressure off of the government to reduce wasteful expenditures and introduce other needed reforms. The downfall in 2011 of the Egyptian government of Hosni Mubarak, in part, may have been an indirect result of these consequences of aid.

Aid programs may actually weaken the institutions that society needs to enhance the process of development and reduce the need for aid. Budget institutions might be weakened by aid, especially if most aid is disbursed as projects with the money not flowing through the budget. Aid agencies need qualified accounts, economists, and financial specialists to design, monitor, and evaluate their projects. By increasing the demand for these skills, aid agencies bid up their wages, making them more expensive for everyone else, including the government (not to mention domestic firms). Aid agencies sometimes recruit the most able and promising local staff, leaving government agencies and the rest of the economy with less-qualified (and usually lower-paid) staff. In Mozambique, after the end of its civil war in the early 1990s, donors came flooding into the country and recruited many of the most-capable government workers, paying upward of five times the government salary and sometimes more than private sector salaries. But the departure of some of its most talented staff deprived the government of needed skills, and weakened government effectiveness as a result.[26]

[25]Aleš Bluír and Javier Hamann, "How Volatile and Unpredictable Are Aid Flows, and What Are the Policy Implications?" IMF Working Paper No. 01/167, International Monetary Fund, Washington, DC, 2001.

[26]Peter Fallon and Luiz Pereira da Silva, "Recognizing Labor Market Constraints: Government-Donor Competition for Manpower in Mozambique," in D. Lindauer and B. Nunberg, eds., *Rehabilitating Government* (Washington, DC: World Bank, 1994).

This process is not limited to the budget office: It can affect the central bank, the ministry of health (which might lose physicians or epidemiologists), the ministry of education, and other agencies. Aid agencies might be able partially to countervail these tendencies by supplying technical assistance to train government workers (although some then take other jobs) or otherwise strengthen institutional systems. Over time, there may be some benefit, as the increased wages entice more school graduates to become accountants and financial experts. In any case, aid agencies often do not take into account these possible deleterious impacts.

To some extent, the dependency can work both ways, as aid agencies become accustomed to operating large-scale programs. Donor agencies, in effect, are asked to work themselves out of their jobs by making aid less necessary and less important over time. But, like any agency, most aid agencies like to be bigger and have more aid flows to disburse. Individuals working on specific projects often like to see them continued over time; and the larger the programs, the more influence they may have over government policy choices. Promotions and other rewards often are geared to the size of the aid program they manage. Thus the incentives facing the donors sometimes encourage dependency between donor and recipient.

Proponents of View 2 point to a body of research that finds little relationship between aid and growth. Keith Griffin and John Enos were among the first to report empirical research questioning the effectiveness of aid, finding negative simple correlations between aid and growth in 27 countries. Since then, other studies concluded that there is no relationship or even a negative relationship between aid and growth,[27] in contrast to the studies cited earlier that support View 1.

VIEW 3. AID HAS A CONDITIONAL RELATIONSHIP WITH GROWTH, STIMULATING GROWTH ONLY UNDER CERTAIN CIRCUMSTANCES, SUCH AS IN COUNTRIES WITH GOOD POLICIES OR INSTITUTIONS

This perspective begins by accepting the idea that aid has had mixed results: Even where research has found a generally positive relationship, no one claims that aid has worked across all countries all the time. It recognizes that aid seems to have stimulated growth in some countries under certain circumstances but not in others and focuses on trying to decipher the key characteristics that might explain these

[27]See, for example, K. B. Griffin and J. L. Enos, "Foreign Assistance: Objectives and Consequences," *Economic Development and Cultural Change* 18, no. 2 (July 1970), 313–27; Paul Mosley, "Aid, Savings, and Growth Revisited," *Oxford Bulletin of Economics and Statistics* 42, no. 2 (1980), 79–96; Peter Boone, "The Impact of Foreign Aid on Savings and Growth," Working Paper no. 677, Centre for Economic Performance, London School of Economics, London, 1994; William Easterly, Ross Levine, and David Roodman, "New Data, New Doubts: A Comment on Burnside and Dollar's 'Aid, Politics, and Growth,'" *American Economic Review* 94, no. 3 (June 2004); David Roodman, "The Anarchy of Numbers: Aid, Development, and Cross-Country Empirics," Working Paper no. 32, Center for Global Development, Washington, DC, July 2003. For a review, see Clemens et al., "Counting Chickens When They Hatch."

differences. This view is represented by Figure 14–5c. Three "conditional" explanations have emerged, suggesting that the relationship between aid and growth might depend on the characteristics of the recipient country, the type of aid being provided, or the way in which donors provide it.

CHARACTERISTICS OF THE RECIPIENT COUNTRY The most influential of the conditional perspectives is that the impact of aid depends on the quality of institutions and policies in the recipient country. According to this view, in countries with poor macroeconomic and trade policies, high levels of corruption, and low accountability of government officials, aid is likely to have little or no impact. By contrast, in countries with reasonably good policies and institutions, aid programs can help accelerate growth. Jonathan Isham, Daniel Kaufmann, and Lant Pritchett initiated this line of research by finding that rates of return on aid-financed investments were higher in countries with strong civil liberties and other measures of governance. Craig Burnside and David Dollar took the next step by finding a significant positive relationship between aid and growth in countries with good policies and institutions and no relationship otherwise.[28] Other researchers explored the possibility that the impact of aid may differ depending on the type of government, quality of human capital, location in the tropics (presumably a proxy for health), the magnitude and frequency of export shocks, and other factors.

Although subsequent analysis cast doubt on some of these results, the idea has had an enormous influence on donor policies, probably because the conclusions of a differential effect are consistent with the experience of many development professionals. These findings have led to a shift among donors to be more "selective" in allocating foreign aid, to provide more of it to countries with relatively stronger institutions and policies, as we discuss later in the chapter.

TYPE OF AID Different kinds of aid might affect growth in different ways. One study disaggregated aid flows into those most likely and least likely to affect growth within a few years, if at all.[29] It separated aid into three categories:

- Emergency and humanitarian aid, likely to be negatively associated with growth because it increases sharply at the same time growth falls because of an economic shock.
- Aid that might affect growth only after a long period of time, if at all, and so a growth impact may be difficult to detect, such as aid for health, education, the environment, and to support democracy.

[28]Jonathan Isham, Daniel Kaufmann, and Lant Pritchett, "Governance and Returns on Investment: An Empirical Investigation," Policy Research working paper no. 1550, World Bank, 1995; Craig Burnside and David Dollar, "Aid, Policies, and Growth," *American Economic Review* 90, no. 4 (September 2000), 847–68; Paul Collier and David Dollar, "Aid Allocation and Poverty Reduction," *European Economic Review* 45, no. 1 (2002), 1–26; World Bank, *Assessing Aid: What Works, What Doesn't, and Why* (New York: Oxford University Press, 1998).

[29]Clemens et al., "Counting Chickens When They Hatch."

- Aid directly aimed at affecting growth (building roads, ports, and electricity generators, or supporting agriculture).

It found a strong relationship between the third type of aid and growth, but the relationship with the other types was less detectable. The study found some support for the proposition that the third subcategory of aid had an even stronger impact in countries with stronger institutions.

DONOR PRACTICES Many analysts argue that differences in donor practices are likely to influence aid effectiveness. Multilateral aid might be more effective in stimulating growth than bilateral aid because less of it is determined by political factors (although some argue just the opposite, that multilateral agencies tend to be too large, unfocused, and less directly accountable to taxpayers). Aid "tied" to purchases of good and services in the donor countries or used to finance conferences and international meetings might be less effective than other aid. Large aid bureaucracies add to costs and slow down disbursements, making aid less effective. Donors that coordinate with other funders and recipient governments may be more effective than those that operate completely on their own. Donors with more effective monitoring and evaluation systems might be better able to channel aid to its most productive uses, enhancing overall effectiveness. An influential view that emerged in the late 1990s is that aid might be more effective where there has been a participatory approach among government and community groups in recipient countries in setting priorities and designing aid-supported programs, a topic we return to later in the chapter. Substantial debate centers around these issues, and there is little doubt that donor practices are critical, but to date there has been very little systematic research connecting specific donor practices to aid effectiveness.

In summarizing the aid and growth research, it seems that aid has been successful in some countries but not others, with the overall trend a subject of debate. Further research is looking beneath the surface to reveal what types of aid are most effective, which are ineffective, and the precise conditions under which aid has the largest impact on growth. Just as with the evidence on the causes of economic growth more generally discussed in Chapter 3, there is still much that we do not know about the relationship between aid and growth.

DONOR RELATIONSHIPS WITH RECIPIENT COUNTRIES

The criticisms about foreign aid and the evidence that it appears to have been effective in some countries but not in others led to debates about how aid programs can be improved to more effectively support growth and development. But the challenge is not easy. Aid programs face some inherent difficulties in trying to achieve a wide range of objectives (which may differ between donor and recipient), provide financial oversight, and ensure results. In this section, we first explore some of the challenges in more depth, then turn to some specific changes that have been suggested and in some cases implemented by donors and recipients in an attempt to make aid more effective.

THE PRINCIPAL-AGENT PROBLEM

A key issue facing aid agencies is that there is only an indirect and distant relationship between the people actually providing the financing (taxpayers in donor countries) and the intended ultimate beneficiaries of aid projects (poor people living in low-income countries). Many institutions, organizations, and transactions are in between, and the decisions made along the way may not be in accord with the wishes or best interests of either the original taxpayers or the ultimate beneficiaries. All public-sector agencies and many private companies are faced with the **principal-agent problem**, but the international dimension makes it an even greater challenge for aid. Economist Bertin Martens analyzed the principal agency problem for aid agencies, and our account closely follows his.[30]

Principals in a private company (the owners), club (the members), or public administration (taxpayers) cannot make all decisions and carry out all tasks themselves, so they must delegate these responsibilities to *agents* to work on their behalf: managers, employees, elected officials, and civil servants. But agents have their own goals and motivations, which may not be the same as the principals'. Agents also have more information than the principals and can use that information in ways that run counter to the principals' interests. Therefore, principals are faced with the problem of writing contracts and establishing rules that more closely align agents' interests with their own. These issues are particularly important for public-sector agencies because they tend to have multiple objectives (not just profit) and their many principals may not agree on which objective holds the higher priority. These problems make it very difficult to match incentives, such as salary, bonuses, and promotions, with performance indicators.

Most aid programs have a long, complex chain of principal-agent relationships, starting with the taxpayers who delegate authority to elected officials, who in turn become principals who delegate authority to a new set of agents, the heads of aid agencies. These relationships continue to aid agency employees, contractors, and consultants. In the recipient country, similar relationships lie between the ultimate recipients, their government, and those who actually implement programs. In most public agencies, there is considerable slippage throughout these relationships, but

[30]Bertin Martens, "Introduction" in Berten Martens, ed., *The Institutional Economics of Foreign Aid* (Cambridge: Cambridge University Press, 2004).

the problem is compounded in aid agencies by the physical separation of the original taxpayers and ultimate beneficiaries. In domestic public programs (such as trash collection or local schools), the taxpayers and ultimate beneficiaries are the same people, so they may have clearer information about success or failure and can reward or penalize their agents accordingly by reelecting them or voting them out of office. But this feedback loop is broken for aid agencies, as Martens points out:

> A unique and striking characteristic of foreign aid is that the people for whose benefit aid agencies work are not the same as those from whom the revenues are obtained; they actually live in different countries and different political constituencies. This [separation] blocks the normal performance feedback process: beneficiaries may be able to observe performance but cannot modulate payments (rewards to agents) as a function of performance. Although donors are typically interested in ensuring that their funds are well spent, it is extremely difficult for them to do so, since there is frequently no obvious mechanism for transmitting the beneficiaries' point of view to the sponsors.[31]

The principal-agent problem affects nearly all aspects of aid delivery, including program design, implementation, compensation, incentives, evaluation, and allocation of funding. The problem can never be fully avoided: Private companies face similar issues between owners, managers, and employees, as do private aid foundations and charities. The challenge is to design institutions and incentives to try to mitigate these problems as much as possible to clarify goals, objectives, incentives, and rewards. A key challenge for donors is how best to apply conditions to their loans to encourage recipients to act more in accord with the donors' (and possibly the ultimate beneficiaries') interests and wishes.

CONDITIONALITY

Donors often require that recipient countries adopt specific policies, or packages of policies, as prerequisites for funding; and this **conditionality** is one of the most controversial aspects of aid. Broad policy conditions are most often associated with financing from the IMF and World Bank, but all donors use them to some extent. Many bilateral donors take their lead from these two multilateral organizations and do not provide the full amount of their aid until the recipient country has met IMF and World Bank conditions. The IMF typically requires that countries adopt a more flexible exchange rate, smaller budget deficits, slower growth of the money supply, a buildup of foreign exchange reserves, privatization of certain state-owned enterprises, a reduction in import restrictions, and the implementation of broad anticorruption measures. World Bank conditions sometimes reinforce these broad policy

[31]Martens, "Introduction," 14.

reforms and may add some sector-specific requirements, such as liberalizing fertilizer markets before providing an agriculture loan.

In many cases, the specific policy conditions required by the IMF and World Bank are justifiable and often supported by at least some people within the recipient governments. But, other times, many people believe that IMF and World Bank conditions go too far and their conditions are harder to justify, especially when the rationale for specific reforms are less clear-cut and seen by critics as based more on ideology than hard facts and sensible economics. For example, while privatization of state-owned marketing boards, retail outlets, or trading establishments is generally not controversial, privatization of public utilities is much more open to debate. Many countries may need to impose fiscal discipline as required by the IMF, but the Fund is often accused of imposing much stricter discipline than is really necessary to achieve stability, at a cost of dampening aggregate consumption and expenditures on important social programs. Sometimes, the donors simply impose too many conditions, seemingly wanting the recipient country to fix everything at once without showing any sense of priority or feasibility. Turkey's "Letter of Intent" with the IMF in April 2003 included a table listing 131 very specific policy actions (with dozens more subcategories of actions) that the government promised to undertake as part of its program.[32] The IMF admitted that, at times, it has gone too far, as with its program in Indonesia after the financial crisis of 1997.[33]

While donors are often criticized for imposing too many conditions, they are almost as often criticized for not imposing *enough* conditions. Some advocates that criticize the IMF for imposing too much fiscal austerity also insist that it require governments to spend a minimum amount on health and education. The World Bank is often asked to add conditions to force governments to take specific actions, for example, on projects that have potential environmental consequences. This can lead to difficult dilemmas. Sometimes governments ask the World Bank to be one of many co-funders for a project, hoping that World Bank participation will provide credibility and security. In return, the World Bank typically wishes to require environmental safeguards or anticorruption measures. But because the World Bank is only one lender, its leverage may be limited. If the World Bank requires too many conditions, the government can just go ahead without them (and without the environmental safeguards), but if they ask for too few, they may find themselves funding a project with inadequate conditions.

The rationale for these conditions is straightforward: Donors believe these broad-based conditions are important for growth and development, and without them, providing aid is futile. It is easiest to see this rationale in extreme cases: If gov-

[32]See International Monetary Fund, "Turkey: Letter of Intent," April 5, 2003, available at www.imf.org/external/np/loi/2003/tur/01/index.htm; accessed February 2012.

[33]IMF Independent Evaluation Office, "The IMF and Recent Capital Account Crises: Indonesia, Korea, and Brazil," (Washington, DC: IMF, 2003). Available at www.imf.org/external/np/ieo/2003/cac/pdf/all.pdf.

ernment policies have led to high rates of inflation, an overvalued exchange rate, massive inefficiencies and waste of public spending, and extensive corruption, then providing aid, whatever the specific purpose, without requiring fundamental change provides no benefits and perhaps perpetuates the damage. Some even argue that the primary purpose of aid is not the money but for aid to act as a lever for the policy reforms. The conditionality debate is a microcosm of the principal-agent problem: A donor requests a recipient to take specific actions in return for receiving aid, but the recipient may have different objectives and controls sufficient information to make compliance difficult.

Cornell economist Ravi Kanbur points out two further problems with conditionality. First, it is not always clear what conditions are the most appropriate to ensure sustained growth and development. Mahbub ul Haq, an influential development adviser long associated with the UNDP, once commented that sub-Saharan Africa, "often receives more bad policy advice per capita from foreign consultants than any other continent in the world."[34] Development doctrine, as discussed in Chapter 5, has swung from a state-led approach in the 1950s and 1960s, to basic human needs in the 1970s, to a macroeconomic approach focused on open markets in the 1980s and 1990s, to a focus on institutions beginning in the mid-1990s, to a greater focus on private sector led growth in the 2000s. As a result, the list of conditions is constantly evolving.

Second, conditionality does not seem to work. Most analysts agree that governments implement reforms only when it is in their interests to do so, and donor conditions have little, if any, impact on that decision. They perhaps can spur governments to implement changes faster than they otherwise would, or provide support to reformist elements in policy debates, but cannot persuade governments to do what they really do not want to do. Many donors continue to disburse aid even when recipients fail to meet conditions, sometimes repeatedly so. Over time, recipients learn that aid flows do not necessarily depend on meeting stated conditions, a process that gradually undermines the aid institutions and the conditions they attach. Donors are faced with their own internal incentives to continue to disburse aid to support the contractors and recipients that depend on it. They also face a "Samaritan's dilemma," that withdrawing aid would create short-term pain for the very people it is aimed to help.[35]

In the end, there are no clear-cut rules for conditionality. Striking the right balance between responsible oversight and accountability, on the one hand, and ensuring against

[34]Mahbub ul Haq, "Does Africa Have a Future?" *Earth Times New Service*, January 1998.

[35]Ravi Kanbur, "The Economics of International Aid," in Serge Christophe-Kolm and Jean Mercier Ythier, eds., *Handbook of the Economics of Giving, Altruism, and Reciprocity: Applications* (Amsterdam: North Holland, 2006). Also see Jakob Svensson, "Why Conditional Aid Does Not Work and What Can Be Done About It," *Journal of Development Economics* 70, no. 2 (2003), 381–402; William Easterly, *The Elusive Quest for Growth* (Cambridge: MIT, 2002).

high bureaucratic obstacles and the imposition of unnecessary controls or unwarranted policy changes, on the other, requires flexibility, judgment, and the ability to balance multiple objectives.

IMPROVING AID EFFECTIVENESS

Since the late 1990s, as global aid flows began to rise, there has been increased discussion and debate about how aid programs could be strengthened and become more effective in supporting growth and development. These debates recognized some of the weaknesses in aid programs and resulted in some specific ideas for change. The "Paris Declaration on Aid Effectiveness and the Accra Agenda for Action" is perhaps the clearest articulation of the consensus on best practices in aid delivery.[36] In recent years, donor agencies began to put some of these ideas in practice, and some donor practices changed noticeably as a result.

COUNTRY SELECTIVITY One influential idea is that donors should be more selective about which countries they provide aid to, based on the view that aid works best in countries with good policies and institutions. In the strongest version of this view, aid should be provided *only* to countries that meet these criteria and not otherwise, with more going to countries with the highest levels of poverty. A more moderate view is that *more* aid should be allocated to countries with stronger policies and institutions but continue to provide targeted aid to some countries with relatively poor institutions, especially in postconflict situations. This proposal takes a turn on the conditionality debate: Instead of providing aid to encourage reforms, provide it to countries that already decided to implement key reforms. Economists Paul Collier and David Dollar suggested a "poverty-efficient" allocation of aid in which funding would be provided to the poorest countries with relatively stronger policies and institutions to maximize the impact of aid on global poverty reduction.[37]

Donors began to move in this direction. The World Bank uses its Country Policy and Institutional Assessment index to determine partly the allocation of its concessional IDA funds. Several European donors moved toward providing broad budget support or financing for sector-wide approaches, but only for a relatively small number of countries considered to be the most responsible. The U.S. Millennium Challenge Corporation (MCC) provides aid to only a small number of recipient countries, based largely (although not completely) on their performance on 17 indicators of policies and governance.[38] As of late 2011, the MCC had signed compacts with 23 low-income and lower-middle-income countries around the world.

[36]See the Organization for Economic Cooperation and Development (2008), "The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action," available at www.oecd.org/dataoecd/11/41/34428351.pdf; accessed February 2012.

[37]Collier and Dollar, "Aid Allocation and Poverty Reduction."

[38]Steven Radelet, *Challenging Foreign Aid: A Policymaker's Guide to the Millennium Challenge Account* (Washington, DC: Center for Global Development, 2003).

Because so much aid is allocated for political, security, and other foreign policy reasons, there are limits to how far donors are likely to go in reallocating their aid based on strict economic development criteria. This is especially true for the major bilateral donors but is true for multilateral donors as well. One frequent suggestion is for donors to more clearly separate funding primarily aimed at foreign policy goals from funding aimed at development. This would allow programs to be designed, implemented, and evaluated in different ways so donor country governments, their taxpayers, and recipients could better understand and appraise aid effectiveness.

RECIPIENT PARTICIPATION A second influential idea is that aid has been weakened by donor domination in setting priorities, designing programs and projects, choosing implementers (often consulting firms from the donor country), monitoring and evaluating results, and that aid recipients should play a much larger role in these areas. In this view, bureaucrats and activists from donor countries design too many programs, leading to a poor choice of priorities, flawed design, or weak commitment among recipients for programs they do not feel are their own. Advocates have pushed for a more participatory approach in which various groups in recipient countries (government, NGOs, charities, the private sector) play a more active role. The idea is to eliminate some of the problems in the long chain of principal-agent relationships and more tightly integrate the ultimate beneficiaries in key aspects of the aid-delivery process. This might have two benefits. First, projects might be better designed, with a more accurate view of the highest priorities and the most appropriate implementation methods to meet local needs. Second, increasing recipient participation in the design and implementation process may provide them with more ownership of the activity and a higher stake in ensuring its success. One of the first movements in this direction was the introduction of Poverty Reduction Strategy papers as the basis for World Bank and IMF debt relief and other financing. Similarly, both the Global Fund to Fight AIDS, Tuberculosis, and Malaria and the Millennium Challenge Corporation rely on a significant degree of local participation in designing and implementing the programs they finance. USAID's Feed the Future program, which aims to improve food security by supporting increased agricultural production and improved nutrition, relies on country strategies developed by local leaders and national experts.

While the participatory approach holds out promise and has been increasingly used since the early 2000s, there is no clear empirical evidence yet on the extent to which (or the circumstances under which) it improves aid effectiveness. There is a clear and inescapable tension between country ownership, on the one hand, and donor priorities and conditionality, on the other. Donors are more likely to facilitate a participatory approach in countries in which governments show a strong commitment to sound development policies and less so in countries with corrupt and dictatorial governments.

HARMONIZATION AND COORDINATION Managing aid flows from many different donors can be a constant challenge for recipient countries because different donors tend to implement their own initiatives and insist on using their own unique processes for initiating, implementing, and monitoring projects. Recipients can be overwhelmed by donor requirements to provide multiple project audits, environmental assessments, procurement reports, financial statements, and project updates. According to the World Bank, developing countries typically work with 30 or more aid agencies across a wide variety of sectors, with each sending an average of five missions a year to oversee their projects. Governments can find themselves hosting three or more aid missions a week.[39] Many recipient countries have only a limited number of skilled and highly trained technocrats; and all the donors want to meet with these top people, leaving them with much less time to deal with other pressing concerns. The government of Tanzania, which hosts several hundred aid missions each year, has introduced a "quiet time" from April to August of each year during which it asks donors to minimize meetings and missions so that the government has time to adequately prepare its annual budget.

These concerns have led to numerous suggestions and pledges for donors to more closely coordinate their activities; harmonize their accounting, monitoring, and evaluation systems; or pool their funds.[40] Some progress has been made in the form of donors providing more aid as budget support in certain countries, acting together through joint missions, and agreeing to use similar monitoring and evaluation procedures. At the same time, some newer donor initiatives appear to want to use their own new methodologies, which could compound this problem going forward.

RESULTS-BASED MANAGEMENT The emphasis on demonstrating the effectiveness of aid has led to calls for improved monitoring and evaluation and results-based management. In this view, aid programs should aim to achieve very specific quantitative targets, and decisions about renewing or reallocating aid going forward should be based on those results. There are three basic objectives. First, results-based management can help donors allocate funds toward programs that are working. Second, ongoing reviews can detect problems at an early stage and help modify and strengthen existing programs. Third, donors and recipients can better learn what approaches have worked and what have not. Stronger monitoring and evaluation helps strengthen the principal-agent relationship so that aid agencies have clearer incentives and taxpayers have better information about the impact of aid on its intended beneficiaries. USAID, for example, introduced in 2011 a new evaluation approach aimed at strengthening the impact of the agency's program on achieving specified results. There has been an explosion in empirical investigations on the impact of development interventions through randomized controlled trials, led by

[39]World Bank Development News Media, "Cutting the Red Tape," February 21, 2003.

[40]Ravi Kanbur and Todd Sandler, "The Future of Development Assistance: Common Pools and International Public Goods," Policy Essay No. 5, Overseas Development Council, Washington, DC, 1999.

the path-breaking work of the Jameel Poverty Action Lab at MIT. These and other similar efforts are leading to a much deeper understanding of what works and what does not work in aid-supported programs around the world.

SUMMARY

- Most aid is given by bilateral donors, but a significant portion is channeled through multilateral agencies. Global aid flows peaked in 1991, then declined in real and nominal terms until 1997, before rebounding again. Official development assistance is higher today, almost $130 billion in 2010, than ever before but not as a share of the GNI of today's developed nations. The United States currently provides the largest dollar amount of aid but is among the smallest in terms of aid as a share of its income.
- For some countries, aid flows are large and significant, while in others they are small. Sub-Saharan Africa received aid flows equivalent to about 5 percent of its income in 2009, or about $53 per person. Because of the war in Iraq, the Middle East received $42 per person in 2009, an amount much higher than the $9 per person received by South Asia, which is a much poorer region.
- For most donors, the primary motivation for providing aid is to support foreign policy objectives and political alliances. Income and poverty tend to be secondary objectives. Country size, commercial and historical ties, and the extent of democracy also play a role.
- There are three broad viewpoints on the relationship among aid, growth, and development. First, some analysts believe that aid supports growth and development by adding to investment and the capital stock, helping in the transfer of technology, supporting key health and education programs, and enhancing economic stability. Second, others believe that aid has no impact on growth and might undermine growth by distorting incentives for private production, encouraging corruption, enlarging the government, or creating aid dependency. Third, some argue that aid works under certain conditions but not others, depending on the policy and institutional environment in the recipient country, the purpose of the aid, or the donor's practices and procedures. The empirical evidence on these relationships is mixed, with different studies reaching different conclusions.
- Aid can influence both saving rates and tax revenues through a host of subtle impacts on prices, preferences, and incentives. Aid flows add to total saving and investment but less than one for one. The fungibility of aid can cause private and government saving to decline as aid increases. The impact on government revenues varies across countries, with some

experiencing a decline and others an increase corresponding to higher aid flows.

- Aid agencies face a classic principal-agent problem, compounded by the fact that the original funders (taxpayers in donor countries) have only indirect and distant connections to the intended ultimate beneficiaries (poor people in low-income countries). A particular challenge for donors is how to place appropriate conditions on their aid. Donors often are criticized for putting too many, too few, or the wrong kinds of conditions on aid, and conditionality in general appears to have been largely ineffective.
- In recent years, donors began to try to make aid more effective by becoming more selective in choosing recipients, encouraging more participation by recipients in program design and implementation, coordinating more closely with each other, and managing programs based on results. It is too early to judge the effectiveness of these changes, but they are likely to affect aid programs for some time to come.