

Foreign aid policy: An introduction

Arne Bigsten*

During the last few years, aid issues have been put high on the political agenda. At the Millennium Summit of 2000, world leaders agreed on a set of common targets, the Millennium Development Goals, for development efforts until 2015. In 2005, proposals for massive increases of aid, in particular to Africa, were presented by the UN (2005) and the Commission for Africa (2005). New measures to deal with the debt burden of poor countries have also been introduced.

In parallel with the renewed political interest in aid issues, there has been a massive outpouring of studies on the impact of foreign aid. The question of whether aid works or not has been approached from different methodological and ideological perspectives, and this seems to be an opportune time to try to take stock of what we really know about the workings of foreign aid. This issue of *Swedish Economic Policy Review* presents results of recent research on foreign aid. The following questions are addressed: What do we know about the relationship between aid and growth and poverty reduction? What are the forces that really determine the aid allocation of donors? What are the characteristics of donor-recipient relationships and how do they determine what is achieved? Can the new approaches to aid evaluation provide better answers to the question of what works and what doesn't? Is there scope for major improvements in Africa through massive aid increases? Have the debt relief measures that have been tried worked? I summarize some of the important points made in the six papers included in this volume, and more comments are provided in the discussants' comments.

In the first paper, *Finn Tarp* describes the historical development of foreign aid and then considers the controversies surrounding the effectiveness of aid. The paper provides a review of attempts to measure the true impact of foreign aid. It is noted that to make valid inferences the evaluator needs to establish a proper counterfactual, and this requires assumptions that may be debatable. Much of the

* *Arne Bigsten is Professor at the Department of Economics, Göteborg University, and member of the Swedish Economic Council.*

evidence from project evaluations has shown the return on projects to be high on average, while doubts have remained about the overall growth impact. The latter concern has during the last decade been addressed in a series of studies trying to measure aid effectiveness. Analysts have mainly used the cross-country panel-data approach, which makes it possible to control for a whole range of variables. At the centre stage in the late 1990s was the result from Burnside and Dollar (2000) that although aid does not work in general, it works in a good policy environment. As a result of this, the policy line of the World Bank and others became that aid should be directed to countries with a good policy environment where it could do some good. However, several authors have found this result to be fragile. The most recent studies find that there is a significantly positive effect of aid on growth, although they are less positive in the tropics. Tarp concludes his review with the observation that the most common result in the literature is that aid has a positive effect on per capita income growth. He also notes that this is not conditioned on good policies, although good policies are of course desirable. Therefore, he argues that donors should not abandon people who are unfortunate enough to be living in poor environments.

In the second paper *Jean-Claude Berthelemy* looks at the aid allocation behaviour of different types of donors. He distinguishes three types, namely individual bilateral donors (DAC members), the European Commission and the non-EC multilaterals. In looking at allocation of aid, he considers three influences, namely the self-interest of the donor (geopolitical or commercial), the needs of the recipients, and their merits. He finds that self-interest plays a major role in bilateral aid (except for some countries, for example the Nordics). It is striking that the EC aid allocation is very much focused on the ACP-countries, while needs or merit don't seem to matter for its aid allocation. For other multilaterals, recipients' needs play a major role, while merit does not. On the whole, bilaterals and multilaterals excluding EC behave very similarly.

Jakob Svensson analyses institutional features of aid and their implication for its effectiveness. Since beneficiaries and financiers live in different countries, the normal information/accountability feedback loop is broken. No one will really be held accountable if the aid intervention does not work out. The aid set up provides little rewards to aid workers for good aid outcomes, and this has led to a disproportionate focus on inputs and aid volumes. Svensson discusses how one

could make donors more accountable by implementing feedback loops and independent evaluation agencies.

He also touches on the problem that multiple agencies may lead to coordination failures. Donor proliferation also leads to increased transaction costs, and projects affect the recipient's financial ability and administrative capacity. If projects have large fixed costs and increasing returns to scale, the impact is reduced by having many small individual projects rather than large ones. And if projects are complementary, there will be benefits of coordination that are not realized when donors act independently. Donors tend to support capital spending, while each donor treats the budget for recurrent expenditures as a common-pool resource. This is a tragedy of the commons problem. One reason for the lack of coordination is that coordination is not costless, but it may also be that donors have conflicting interests. The recent trend towards budget support reduces transaction costs and gives incentives to strengthen the regular budgeting system.

The third problem area discussed by Svensson is that donors and recipients goals are not necessarily aligned. Conditional aid as tried during the structural adjustment era was not successful. Currently, there are attempts to harmonize donor support around the recipient's own system. The ideal sequence would be from country ownership via donor alignment to harmonization, but so far this has been hard to realize. Experimentation and proper evaluations are called for.

Jan Willem Gunning notes the success of evidence based research in medicine and that there is much less support for this in the development field. What is of particular interest is statistical impact evaluation. This can help us identify how much of the change in an outcome variable that can be attributed to an aid intervention. The key is a comparison of results with a counterfactual. Ideally, one would like to compare one group with and one without treatment, and sometimes this can be achieved with randomization and an experimental design. But often one has to resort to quasi-experimental designs. Then, the key is the availability of baseline data. If that is available, one can compare change over time for groups with and without treatment (differences in differences approach). Also if an intervention is gradual, one can use this kind of approach.

Gunning suggests that impact evaluations should also be done at the macro-level by evaluating a sample of activities and then aggregate up. When it comes to budget support, it will be hard to make a clear distinction between treatment and not treatment groups, but if panel

data are available for all possible determinants of outcome, one can use fixed effects estimates. The reduced form approach is a black box technique, but it can be complemented by more informal approaches to understand the linkages. Here, there is much scope and need for experimentation.

The key challenge for donors at present is Sub-Saharan Africa, which has done very poorly in the last 30 years. *Paul Collier* asks what it will take to make a decisive break with the dismal record of the past for Africa. He argues that aid is conditionally important but that it can also be conditionally detrimental. Since the evidence suggests that there are decreasing returns to aid, just scaling it up will not contribute much to further African growth. If we want to scale up aid and have an effect, we need to find new areas where aid can be effectively used. He further argues that aid has had a better development impact than an equivalent amount of revenue received from oil, which suggests that aid organisations generally do contribute something. This is then an argument against sweeping changes of aid into debt relief and budget support.

Collier argues that aid interventions need to be tailored to fit the recipient's specific characteristics. The resource-rich countries have large and often corrupt government sectors, since they earn sizeable resource rents which accrue to the government. The key for this group is to improve the efficiency by which they spend public money, through knowledge transfers and governance conditionality trying to make the government more accountable to its citizens. The resource-scarce coastal economies can develop by diversifying exports. The engine of growth will be private exporting firms. What is needed is an environment that is conducive to new exporters and aid should be geared to support this in various ways. It can support critical export infrastructure and provide guarantees against expropriation. Finally, the resource-scarce and landlocked countries have the most serious problems. They are likely to remain poor for a long time and will therefore need a broad-based development strategy with an emphasis on rural development. New aid should focus on getting the more fortunate neighbours growing and then this will spill over to these unfortunate countries.

Collier discusses different failures of policy choice. The first is the corrupt elite that benefits from a dysfunctional government. Policy conditionality is one option, but it did not work very well. The alternative is governance conditionality aimed at weakening the domi-

nance of the governing elite. Unfortunately, there is a knowledge gap on how to implement governance conditionality. Finally, if the constraint is the lack of administrative capacity in the civil service, this can be developed by various forms of technical assistance. When a decisive turnaround is required, it has been shown to be effective.

Democracy has two important dimensions, electoral competition and checks and balances. Particularly resource rich countries need democracy to avoid elite capture of rents, but checks and balances are needed to prevent that the elections are converted into corrupt patronage games which are financed by the resource rents. One needs system scrutiny to achieve honesty and other systems to achieve efficiency. Since scrutiny is a public good, it is subject to collective action problems, and donors could here help organise citizens. They could also stimulate peer group evaluations. The process of scrutiny also has a severe agency problem. To reduce this, donors could help improve information for the principals, build the capacity to analyse it, and promote incentives for agents to perform. Once a system is there, donors have an important role to play by insisting that rewards and penalties are built in and implemented. Audit systems and parliamentary scrutiny are key areas of intervention.

Collier identifies three areas where aid could make a difference: aid post-conflict; aid to build systems of accountability in resource-rich countries; aid to promote turnarounds and export breakthroughs in resource-scarce, coastal countries. He also suggests a shift from policy conditionality to governance conditionality.

Tony Addison reviews the debt reduction issues that have featured a great deal in the debate. He notes that the lesson from the 1980s was that successful debt management depends on the ability of debtor countries to achieve high growth and foreign exchange earnings. This did not happen in SSA, which was left with a great deal of official debt after two decades of structural adjustment lending. The HIPC initiative came in 1996 and it was enhanced in 1999 with the aim of achieving debt sustainability. To receive debt reductions, countries had to meet certain policy conditions. The G8 agreement of 2005 then evolved into the Multilateral Debt Relief Initiative, which took effect on 1 July 2006.

Debt relief has two impacts. First, it influences the incentives for private investment and second, it has a fiscal effect. The latter makes it possible to increase poverty-related expenditures, for example. There are probably diminishing returns to debt relief like regular aid.

What does the trade-off between using donor money for debt relief and using it for regular aid look like? Recent political initiatives have tended to push the notion that debt relief is the preferred aid option, but one should always keep alternative uses of available money in mind. And the long-term goal should not be to end debt forever, but to move countries to a sustainable debt position and develop marketable debt instruments.

This set of papers covers the recent debate on aid quite well. There are three broad questions that policy makers always need to answer with regard to aid. What type of aid interventions should there be? How should they be organised? And how do we learn from experience? The material presented here should provide much food for thought on all these issues.

References

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