

### **Abstract**

Controversies about aid effectiveness go back decades. Some experts charge that aid has enlarged government bureaucracies, perpetuated bad governments, enriched the elite in poor countries, or just been wasted. Others argue that although aid has sometimes failed, it has supported poverty reduction and growth in some countries and prevented worse performance in others. This new working paper by CGD senior fellow Steve Radelet explores trends in aid, the motivations for aid, its impacts, and debates about reforming aid. It begins by examining aid magnitudes and who gives and receives aid. It discusses the multiple motivations and objectives of aid, some of which conflict with each other. It then explores the empirical evidence on the relationship between aid and growth, which is divided between research that finds no relationship and research that finds a positive relationship (at least under certain circumstances). It also examines some of the key challenges in making aid more effective, including the principal-agent problem and the related issue of conditionality, and concludes by examining some of the main proposals for improving aid effectiveness.

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# A PRIMER ON FOREIGN AID

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## A Primer on Foreign Aid

*“Rich countries must recognize that even with action on trade or agricultural subsidies, there is still a fundamental need to boost resources for developing countries. We estimate that it will take on the order of an additional \$40 to \$60 billion a year to reach the Millennium Development Goals--roughly a doubling of current aid flows--to roughly 0.5 percent of GNP, still well below the 0.7 target agreed to by global leaders years ago. ... Does anybody really believe that the goal of halving absolute poverty by 2015 is not worth this investment?” World Bank President James Wolfensohn, 2002.<sup>2</sup>*

*“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.<sup>3</sup>*

### I. INTRODUCTION

Controversies about aid effectiveness go back decades. Critics such as Milton Friedman, Peter Bauer, and William Easterly have leveled stinging critiques, charging that aid has enlarged government bureaucracies, perpetuated bad governments, enriched the elite in poor countries, or just been wasted. They cite widespread poverty in Africa and South Asia despite three decades of aid, and point to countries that have received substantial aid yet have had disastrous records such as the Democratic Republic of the Congo, Haiti, Papua New Guinea, and Somalia. In their eyes, aid programs should be dramatically reformed, substantially curtailed, or eliminated altogether.

Supporters counter that these arguments, while partially correct, are overstated. Jeffrey Sachs, Joseph Stiglitz, Nicholas Stern and others have argued that although aid has sometimes failed, it has supported poverty reduction and growth in some countries and prevented worse performance in others. They believe that many of the weaknesses of aid have more to do with donors than recipients, and point to a range of successful countries that have received significant aid such as Botswana, Indonesia, Korea, and, more recently, Tanzania and Mozambique, along with successful initiatives such as the Green Revolution, the campaign against river blindness, and the introduction of oral rehydration therapy.

This paper explores trends in aid, the motivations for aid, its impacts, and debates about reforming aid. It begins by examining aid magnitudes and who gives and receives aid. It discusses the multiple motivations and objectives of aid, some of which conflict with each other. It then explores the empirical evidence on the relationship between aid and growth, which is divided between research that finds no relationship and research that finds a positive relationship (at least under certain circumstances). It examines some of the key challenges in making aid more effective, including the principal-agent problem and the related issue of conditionality, and concludes by examining some of the main proposals for improving aid effectiveness.

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<sup>2</sup> James Wolfensohn, “A Partnership for Development and Peace”, in World Bank (2002), *A Case for Aid*, p. 11.

<sup>3</sup> Jesse Helms, “Towards a Compassionate Conservative Foreign Policy.” Remarks delivered at the American Enterprise Institute January 11, 2001. [www.aei.org/news/newsID.17927/news\\_detail.asp](http://www.aei.org/news/newsID.17927/news_detail.asp)

## II. DONORS AND RECIPIENTS

### What is foreign aid?

The standard definition of foreign aid comes from the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), which defines foreign aid (or the equivalent term, foreign assistance) as financial flows, technical assistance, and commodities that are (1) designed to promote economic development and welfare as their main objective (thus excluding aid for military or other non-development purposes); and (2) are provided as either grants or subsidized loans.

Grants and subsidized loans are referred to as **concessional financing**, whereas loans that carry market or near-market terms (and therefore are not foreign aid) are **non-concessional financing**.<sup>4</sup> 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 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.

The DAC classifies aid flows into three broad categories. **Official development assistance** (ODA) is the largest, consisting of aid provided by donor governments to low- and middle-income countries. **Official assistance** (OA) is aid provided by governments to richer countries with per capita incomes higher than approximately \$9,000<sup>5</sup> (e.g., Bahamas, Cyprus, Israel and Singapore) and to countries that were formerly part of the Soviet Union or its satellites. **Private voluntary assistance** includes grants from non-government organizations, religious groups, charities, foundations, and private companies.

When discussing foreign aid, most people have in mind ODA. Global ODA increased steadily from the 1960s until it reached a peak of \$68 billion in 1992, just after the end of the Cold War (Figure 1), and then declined sharply to just under \$55 billion in 1997. Aid flows began to rebound in the late 1990s following calls for greater debt relief and increased aid to new democracies, and accelerated very sharply after the attacks of September 11, 2001, reaching \$92 billion in 2004 (all of these figures would be slightly higher if they included OA). In real terms, total ODA in 2002 was about the same as in 1992, and by 2004 was about 12 percent higher. Measured as a share of donor income ODA fell sharply during the 1990s, and has rebounded only slightly. Donors have pledged to continue to increase aid, most recently in July 2005 when the heads of state of the Group of 8 industrialized countries promised to double aid to sub-Saharan Africa by 2010 and triple it by 2015, but growing budget tensions in donor countries may undermine these pledges.

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<sup>4</sup> Non-concessional loans from donor agencies are counted as part of official development *finance*, but not as official development *assistance*.

<sup>5</sup> More precisely, assistance to countries with per capita incomes (for three consecutive years) above the World Bank’s “high income” threshold, but the DAC makes some exceptions.

## Who Gives Aid, and Who Receives It?

Historically most aid has been given as **bilateral assistance** directly from one country to another. Donors also provide aid indirectly as **multilateral assistance**, which pools resources together from many donors. The major multilateral institutions include the World Bank; the International Monetary Fund; the African, Asian, and Inter-American Development Banks, and various United Nations agencies such as the United Nations Development Programme.

In terms of total dollars, the United States has consistently been the world's largest donor (except in the mid-1990s when Japan briefly topped the list). In 2004 the U.S. provided \$19.7 billion in ODA, with Japan, France, the United Kingdom, and Germany the next largest donors. (Including OA, the U.S. provided a total of \$21.3 billion). However, when aid is measured as a share of donor income, the most generous donors are Norway, Denmark, Luxembourg, the Netherlands, and Sweden, each of which provided between 0.79-0.92 percent of GDP in 2004. Saudi Arabia provided aid equivalent to about 0.69 percent of its income. The United States is one of the smallest donors by this measure at about 0.17 percent of U.S. income in 2004, just over half of the 1970 level of 0.32 percent and less than one-third of the U.S. average during the 1960s. Donors have pledged since the 1960s to devote 0.7 percent of their income as aid, most recently at Financing for Development Conference in Monterrey in March 2002, but only a handful of small donors have achieved this level of aid.

150 countries and territories around the world received aid in 2004. Table 1 shows the largest ten recipients, each of which received more than \$1.4 billion. Iraq and Afghanistan together received nearly \$7 billion. These amounts are unprecedented for two countries and account for about 7.5 percent of the global total. The amounts provided to other countries shown in the table are historically more typical for large recipients.

Aid is typically measured in one of three ways: total dollars, as a share of GDP, or per capita. Each measure reveals different things. Total dollar amounts clearly are important, but they do not tell the entire story. Aid measured as a share of GDP indicates its size relative to the entire economy, and is perhaps the most common measure. But it can be misleading since a high ratio can be indicative of low GDP or a large amount of aid. The amount of aid needed to immunize 1 million children can look like a large share of GDP in a poor country and a small share of GDP in a richer country, when the amount per child might be roughly the same. On a per capita basis, the aid flows to some of the largest recipients are fairly small. Bangladesh received \$1.4 billion in aid in 2004, but this was equivalent to just 2 percent of its GDP or about \$10 per Bangladeshi. By contrast, Nicaragua received a slightly smaller amount, \$1.2 billion in 2004, but for its 5.5 million people this was equivalent to about \$225 dollars per person. For small countries, a little bit goes a long way. Tiny Sao Tome and Principe received just \$33 million, but this translated into 67 percent of GDP and about \$209 per person. Thus, to get a clear picture, it is helpful to look at all three measures of the amount of aid.

On a regional basis, sub-Saharan African countries received aid flows averaging 5.3 percent of GDP in 2004, or \$36 per person (Table 2). Two other regions – Europe and Central Asia, and North Africa and the Middle East – received more than \$25 per person, although aid receipts were a much smaller share of their incomes. For low-income countries around the world, donors

provided aid averaging about \$14.5 per recipient. Donors provide only slightly less per person to upper-middle incomes, even though their incomes are much higher.

Generally speaking, aid is one of the largest components of foreign capital flows to low-income countries, but not to most middle-income countries, where private capital flows are more important. Aid flows averaged 2.8 percent of GDP in low-income countries in 2004, but just 0.2 percent of GDP in upper-middle-income countries. It is commonly claimed that the decline in aid flows to developing countries in the 1990s was more than offset by a rise in private capital. While this is true for developing countries in aggregate, the rise in private capital flows was heavily concentrated in a handful of middle income countries. In low-income countries, private capital rose much more slowly, and remained significantly smaller than aid.

### **Why do Donors Give Aid?**

Donors have a variety of motivations for providing aid, only some of which are directly related to economic development. There is little question that foreign policy and political relationships are the most important 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 with little regard as to whether the aid actually was used to support development. The two largest recipients of U.S. foreign aid (including both OA and ODA) from 1980 until very recently were Israel and Egypt, as the U.S. provided financial support to back the 1979 Camp David peace agreement. Beginning in 2002 Iraq became the largest aid recipient in the world, and its reconstruction is likely to become among the largest single foreign aid program ever recorded. 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. Many donors provide significant aid to their former colonies as a means of retaining some political influence (Alesina and Dollar, 2000).

Many people see the main rationale for aid as fighting poverty, and although this is less important than political considerations in donor allocation decisions, it still plays an important role. Donors generally provide their most concessional aid to the poorest countries, and some aid programs are designed explicitly with this objective in mind. For example, the World Bank's concessional financing arm – the International Development Association (IDA) -- has an income ceiling (\$965 per capita in 2004). Once countries reach that ceiling, in most cases they "graduate" from IDA to non-concessional IBRD loans. Other programs have less formal graduation rules, but still tend to provide less aid as incomes grow.

Country size matters as well. Large countries, such as Bangladesh, Indonesia, Nigeria, and Pakistan receive relatively small amounts of aid on a per capita basis, even though hundreds of millions of people live in poverty in these countries. By contrast, some small countries receive very large amounts. 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.

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 donors "tie" portions of their aid by requiring that certain goods and services be purchased from firms in the donor's home country, or that it be used for specific

purposes that support groups in the donor countries (such as universities or business consulting firms). Automobiles, airline tickets, and consulting services financed by U.S. foreign aid in most cases must be purchased from U.S. firms. Tying aid can give it more political support at home, but it can also make it more costly and less effective. If funds must be spent in the donor country, it reduces competition for services so that donors do not always use the least cost provider. For example, the U.S. requires that food aid be purchased in the U.S. and shipped in U.S. carriers to recipient countries, which can be much more expensive and take much longer than if food was purchased in a neighboring country. The means that recipients received much less value for each dollar of aid allocated to it than they otherwise could. One study found that tying aid added 15-20 percent to its cost, thus significantly reducing its impact on recipient countries. Donors have begun to reduce the amount of aid that they tie, but the practice is still widespread among some donors. The U.S. no longer reports the share of its aid that is tied, but historically it has been around 75 percent. Greece ties about 70 percent of its aid, and Canada and Austria more than 40 percent. By contrast, Ireland, Norway, and the U.K. do not tie any of their aid.

### **III. AID, GROWTH, AND DEVELOPMENT**

Most foreign aid is designed to meet one or more of four broad economic and development objectives: (1) to stimulate economic growth through building infrastructure, supporting productive sectors such as agriculture, or bringing new ideas and technologies, (2) to strengthen education, health, environmental, or political systems, (3) to support subsistence consumption of food and other commodities, especially during relief operations or humanitarian crises, or (4) to help stabilize an economy following economic shocks.

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 faster growth. But at a very broad level, there is no apparent simple relationship between aid and growth, as shown in Figure 2. Some countries that have received large amounts of aid have recorded rapid growth, while others have recorded slow or even negative growth. At the same time, some countries that have received very little aid have done very well, while others have not.

What does the absence of a simple relationship mean? For some observers, it is evidence of a failure of aid to achieve its basic objectives. But for others this simple correlation is misleading, since other factors affect both aid and growth. Some countries that have 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 might 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 following 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. Three broad views have emerged on the relationship between aid and growth.<sup>6</sup>

**1. Aid has a positive relationship with growth on average across countries (although not in every country), but with diminishing returns as the volume of aid increases.** There are three key channels through which aid might spur growth:

- First, the classic view is that aid augments saving, finances investment, and adds to the capital stock. In this view, poor countries are unable to generate sufficient amounts of saving to finance the investment necessary to initiate growth, or at best only enough for very slow growth. 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 (Sachs, et. al., 2004). A related argument is that aid might help relax a foreign exchange constraint in countries that earn relatively little foreign exchange, a view that was popularized through the early “two-gap” models of economic growth.
- Second, aid might increase worker productivity through investments in health or education.
- Third, aid could provide a conduit for the transfer of technology or knowledge from rich countries to poor countries by paying for capital goods imports, through technical assistance, or through direct transfer of technologies such as the introduction of new seeds and fertilizers in the Green Revolution.

Several early studies found a positive relationship between aid and growth (e.g., Papenek, 1973; Levy, 1988), but this strand of the literature took a significant turn in the mid-1990s when researchers began to investigate whether aid might support growth with diminishing returns. Oddly – given Solow’s response to the Harrod-Domar model in the 1950s – research until the mid-1990s only tested a linear relationship, a specification which persists in some studies today. A large group of studies that allow for diminishing returns have found a positive relationship.<sup>7</sup> These studies have received much less public attention than those that have found a zero or conditional relationship, but since the mid-1990s the majority of published research on the topic has found a positive relationship either by allowing for diminishing returns, or by testing for conditional relationships, as explored below. These studies do not conclude that aid has always worked in every country, but rather that *on average* and controlling for other factors, higher aid

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<sup>6</sup> This summary draws heavily from the review in Clemens, Radelet, and Bhavnani (2004). For another recent review of the literature see Hansen and Tarp (2001).

<sup>7</sup> Hadjimichael and others, 1995; Durberry and others, 1998; Dalgaard and Hansen, 2000; Hansen and Tarp 2000 and 2001; Lensink and White, 2001; and Dalgaard and Tarp, 2004; Clemens, et. al. (2004).

flows have led to more rapid growth. In terms of Figure 2, 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 the top panel of Figure 3.

Aid also could have a positive impact on development outcomes other than growth, such as health, education, or the environment. Perhaps the best documented area is health, where aid-supported programs have contributed to the eradication of small pox, the near-eradication of polio, control of river blindness and other diseases, the spread of oral rehydration tablets to combat diarrhea, and the dramatic increase in immunization rates in developing countries since 1970 (Levine, et. al., 2004). Undoubtedly, much aid aimed at health has also been squandered. But beyond specific case studies, there is little systematic evidence on the relationship between aid and health, education, income distribution, or other outcomes.

**2. Aid has no affect on growth, and may actually undermine growth.** Peter Bauer was perhaps the most outspoken proponent of this view (e.g., Bauer, 1972), although he never provided systematic empirical evidence to support his argument. Many later empirical studies did reach the conclusion of no relationship between aid and growth,<sup>8</sup> which is represented by the middle panel of Figure 3. These researchers have suggested a variety of reasons why aid might not support growth:

- First, aid simply could be wasted, such as on limousines or presidential palaces, or it could encourage corruption, not just in aid programs but more broadly.
- Second, it can help keep bad governments in power, thus helping to perpetuate poor economic policies and postpone reform. Some argue that aid provided to countries in the midst of war might inadvertently help finance and perpetuate the conflict, and add to instability.
- Third, countries may have limited absorptive capacity to use aid flows effectively if they have relatively few skilled workers, weak infrastructure or constrained delivery systems. (Aid could help redress these weaknesses, but it may not be aimed to do so).
- Fourth, aid flows can reduce domestic saving, both private saving (through its impact on interest rates) and government saving (though its impact on government revenue).
- Fifth, aid flows could undermine private sector incentives for investment or to improve productivity. Aid can cause the currency to appreciate, undermining the profitability of the production of all tradable goods (known as the Dutch disease). Food aid, if not managed appropriately, can reduce farm prices and hurt farmer income.

The last two points merit further discussion. On aid and saving, while foreign aid adds to total saving (since aid is a form of foreign saving), some studies have shown that a dollar of aid adds less than a dollar to total saving and investment, since domestic savings may fall as aid increases. Some of these studies conclude that aid is ineffective because it “leaks” to consumption. This approach is not particularly helpful in the aggregate since large portions of aid in fact are designed specifically to directly increase consumption and not investment, including food aid,

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<sup>8</sup> Griffen and Enos, 1970, Mosley, 1980; Mosley and others, 1987; Dowling and Hiemenz, 1982; Singh, 1985; Boone, 1994; Rajan and Subramanian, 2005.

immunization programs, purchases of textbooks, technical assistance, and the like. Nevertheless, even where aid is aimed 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). There is a wide range of estimates of the offset effect, but most find that \$1 in aid translates to an increase in investment in the range of 33 to 67 cents. Much depends on the particular country, the type of aid, and other factors.

Aid also could undermine incentives for private sector activity. Aid can spur inflation and cause a real appreciation of the exchange rate, which reduces the profitability of production of all tradable goods, creating “Dutch disease” effects.<sup>9</sup> 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. To the extent that these tradable activities are a key source of productivity gains, long-term growth may suffer. Similarly, food aid can sometimes undermine local food production if an influx of food drives down prices (it has less adverse impact on production when it displaces food imports).

The empirical studies that have found no relationship between aid and growth have been influential. However, only a few published studies have reached that conclusion in the past decade. Most of those that do use restrictive models that impose constraints such as a linear relationship between aid and growth, ruling out by assumption the possibility of diminishing returns. Most also only examine aggregate aid, imposing the restriction that all aid has a similar impact on growth, which is not particularly realistic, since famine relief, immunization programs, and road projects are all likely to have very different impacts on growth.

**3. Aid has a *conditional* relationship with growth, helping to accelerate growth under certain circumstances.** This view holds that aid supports growth in some circumstances but not others, and searches for key characteristics associated with the difference. This view is represented by the bottom panel of Figure 3, which shows different aid-growth relationships for different groups of countries. This “conditional” strand of the literature has three subcategories, with the effectiveness of aid depending on the characteristics of the recipient country, the practices and procedures of the donors, or the type of activity that the aid supports.

*Recipient country characteristics.* Jonathon Isham, Dani Kaufmann, and Lant Pritchett (1995) opened this line of research by finding that World Bank projects had higher rates of returns in countries with stronger civil liberties. Craig Burnside and David Dollar (2000), in a very influential study, concluded that aid stimulated growth in countries with good policies, but not otherwise. Other researchers have proposed different country characteristics that might affect the aid-growth relationship, including export price shocks, climatic shocks, the terms of trade, macroeconomic and trade policies, institutional quality, warfare, type of government, and location in the tropics.<sup>10</sup> All of these studies rely on an interaction term between aid and the variable in question, and (not surprisingly) many of the interaction terms are fragile. Easterly, Levine, and Roodman (2004) find that the original Burnside and Dollar results do not hold up to modest robustness checks. Roodman (2004) tests several other “conditional” studies and finds

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<sup>9</sup> See Adam, 2005; Rajan and Subramanian, 2005; Bulir and Lane, 2002; Prati et al, 2003; Younger, 1992.

<sup>10</sup> Collier and Dehn, 2001; Guillaumont and Chauvet, 2001; Chauvet and Guillaumont, 2002; Collier and Dollar, 2002; Burnside and Dollar, 2004; Collier and Hoeffler, 2002; Islam, 2003; and Dalgaard and Tarp, 2004.

most of them to be relatively fragile, although the conclusions of Dalgaard and Tarp (2004) are more robust.

Nevertheless, the view that aid works better (or in a stronger version, aid works *only*) in countries with good policies and institutions has become the conventional wisdom among donors, partly based on this research and partly due to development practitioners that believe this to be the case based on their own experience. The appeal of this approach is that it can explain why aid seems to have supported growth in some “well-behaving” countries but not others. These findings have had an enormous impact on donors (World Bank, 2000). The concept feeds directly into the World Bank’s Performance Based Allocation (PBA) system for distributing concessional International Development Association (IDA) funds, and was the foundation for the United States’ new Millennium Challenge Account (Radelet, 2003).

*Donor practices.* Many analysts have argued that donor practices strongly influence aid effectiveness. For example, multilateral aid might be more effective than bilateral aid, and “untied” aid is thought to have higher returns than “tied” aid, as discussed previously. Many observers argue that donors that have large bureaucracies, do not coordinate with other donors, or have poor monitoring and evaluation systems undermine the effectiveness of their own programs. Two influential and overlapping views argue that aid would be more effective if there were greater “country ownership” or broader “participation” among government and community groups in recipient countries in setting priorities and designing programs. There has been substantial debate about these issues, and in some cases these ideas have begun to change donor practices. But to date there has been very little systematic research connecting specific donor practices to aid effectiveness.

*Type of aid.* Different kinds of aid might affect growth in different ways. Clemens, Radelet, and Bhavnani (2004) disaggregated aid into types most likely and least likely to affect growth within a few years, if at all. They separated aid into three categories: (1) emergency and humanitarian aid (likely to be negatively associated with growth, since aid tends to increase sharply at the same time growth falls following an economic shock); (2) aid that might only affect growth after a long period of time, if at all, and so the relationship may be difficult to detect (such as aid for health, education, the environment, and to support democracy); and (3) aid that is directly aimed at affecting growth (building roads, ports, and electricity generators, or supporting agriculture). It found a strong positive relationship between the third type of aid (about half of all aid) and growth, a result which stood up to a wide variety of robustness checks. As expected, the relationship with the other types was less detectable.

To summarize the aid and growth research, it appears that aid has been successful in some countries but not others. The overall trend is a subject of debate, but most research has found a positive relationship. This research is only beginning to scratch beneath the surface and investigate what types of aid are most effective and the conditions under which aid has the largest impact on growth. Since disputes continue about the determinants of economic growth more broadly, perhaps it is not surprising that the aid-growth relationship continues to be a matter of sharp debate.

## IV. DONOR RELATIONSHIPS WITH RECIPIENT COUNTRIES

The criticisms about aid have 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, provide financial oversight, and ensure results.

### 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. In most aid programs, there is a long and complex chain of principal-agent relationships, starting with the taxpayers that delegate authority to elected officials, who in turn become principals that delegate authority to a new set of agents, the heads of aid agencies, which delegate to agency employees, contractors, and consultants.<sup>11</sup> In the recipient country, there are similar relationships between citizens, their government, and those that actually implement programs. The objectives, incentives and information available to these agents are not always well aligned with the objectives of either the taxpayers or the beneficiaries.

All public sector agencies and many private companies are faced with these principal-agent problems, but the international dimension and physical separation between the original taxpayers and ultimate beneficiaries makes it an even greater challenge for aid. In domestic public programs (such as trash collection or local schools) the taxpayers and ultimate beneficiaries are the same people, so they have clearer information about success or failure and can reward or penalize their agents accordingly by re-electing them or voting them out of office. But this feedback loop is broken for aid agencies. Taxpayers cannot tell if their money is well spent, beneficiaries sometimes do not even know about local programs and each have limited mechanisms for penalties and rewards. Bertin Martens (2004) put it this way:

“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.

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 solved – private companies face similar issues between owners, managers and employees, as do private aid foundations and charities. The challenge is to design institutions and

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<sup>11</sup> For an excellent discussion of the principal-agent problem in aid programs, see Bertin Martens (2004),).

incentives that mitigate these problems as much as possible to clarify goals, objectives, incentives, and rewards. In this regard, one of the key challenges for donors is if, when, and how to apply conditions to their aid, a subject to which we now turn.

## Conditionality

Partly as a result of the principal-agent problem, donors often apply conditions on aid programs to encourage recipients to act more in accord with the donors' (and possibly the ultimate beneficiaries') interests. Donor conditions on recipient actions or policies are among the most controversial aspects of aid. Policy conditionality is most often associated with the IMF and World Bank, but all donors use conditions to some extent.

The rationale for economic policy conditions is straightforward: donors believe that certain policies and actions in different countries are important for growth and development, and that without them providing aid is futile. If government policies have led to high rates of inflation, massive inefficiencies and waste of public spending, and extensive corruption, then providing aid – whatever the specific purpose -- without requiring fundamental change would provide no benefits and perhaps could perpetuate 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.

There are three key problems with conditionality. First, it is not always clear what policy conditions are the most appropriate to ensure sustained growth and development. Development doctrine 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 greater focus on institutions beginning in the mid-1990s. As a result, the list of conditions is constantly evolving. Debate has raged for decades about whether specific IMF and World Bank conditions are justifiable and whether they support or hurt stabilization, growth, and development. And who should bear the costs if donor-imposed conditions make things worse?

Second, 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 should 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 adverse environmental consequences.

Third, 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. Many donors continue to disburse aid even when recipients fail to meet conditions, sometimes repeatedly so. 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.<sup>12</sup>

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<sup>12</sup> See for example Kanbur (2003), Svensson, 2003, and Easterly (2001).

The nature of conditionality has changed over time as the most pressing issues have changed and as donors continue to wrestle with the best ways to apply conditions. During the 1980s, most conditions focused on macroeconomic issues, trade reforms, and privatization, as reflected in IMF and World Bank sponsored structural adjustment programs. During the 1990s, as macroeconomic imbalances improved and following the end of the Cold War, attention shifted to governance, corruption, and institution building. Debate has re-emerged as to whether aid should be conditioned on democratic reforms in recipient countries. Whether governance-focused conditionality is a good idea, or whether it will be more successful than structural and policy conditionalities remains to be seen.

There are no clear-cut rules for conditionality. Striking the right balance between responsible oversight and accountability on the one hand, and ensuring against 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 – none of which are easy for aid agencies to achieve.

### **Improving Aid Effectiveness**

The debates about the strengths and weaknesses of aid have led to specific ideas for change, some of which donors have begun to put into practice. Four stand out.

***Country Selectivity.*** One influential idea is that donors should be more selective about the countries to which they provide aid, based on the view that aid works best in countries with good policies and institutions. In the strongest version, aid should be provided *only* to countries that meet these criteria. A more moderate view is that *more* aid should be allocated to countries with stronger policies and institutions, but some aid should be targeted to countries with weaker policies, especially post-conflict countries. This proposal turns the conditionality debate: instead of providing aid to encourage reforms, give it to countries that have already demonstrated a desire to implement key reforms. In the language of the principal agent problem, donors should spend less time trying to write contracts that force an alignment of incentives and instead give more aid to countries that on their own demonstrate similar motivations and objectives. Some donors have begun to be more “selective,” including the World Bank in the allocation of its concessional IDA funds, some European donors in terms of providing budget support, and the U.S. with its new Millennium Challenge Account. But since 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 this direction.

***Recipient Participation and Country Ownership.*** Many analysts argue that aid has been weakened by donor domination in setting priorities, designing programs and implementing projects, and push for either a more “country led” approach in which recipient governments take a stronger role, or a “participatory” approach in which various groups in recipient countries (government, NGOs, charities, the private sector) play a more active role. Note that country ownership and a broad participatory process are not the same thing: the former implies that recipient countries take the lead in setting priorities and programs; the latter implies that broad participation by the public (and not just the government) is required.

In either case, 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. The World Bank and IMF (through their “Poverty Reduction Strategy Papers”), the Global Fund to Fight AIDS, Tuberculosis and Malaria and the Millennium Challenge Corporation have all moved towards greater local participation in designing and implementing the programs they finance. This approach is new, so there is no 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 is a huge challenge for recipient countries, since different donors usually insist on using their own unique processes for initiating, implementing, and monitoring projects. Recipients can be overwhelmed by requirements for 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.<sup>13</sup> The donors all want to meet with the same top government officials, leaving them with much less time to deal with pressing matters. These concerns have led to numerous suggestions for donors to more closely coordinate their activities; harmonize their systems; or “pool” their funds (Kanbur and Sandler, 1999). But while there has been some progress, the pace of change amongst the donors seems glacial.

***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 re-allocating aid going forward should be based on those results. There are three basic objectives: (1) helping donors allocate funds towards programs that are working; (2) detecting problems at an early stage to help modify and strengthen existing programs; and (3) improving the design of future programs. Stronger monitoring and evaluation would help improve principal-agent relationships so that aid agencies have clearer incentives and taxpayers have better information about the impact of aid on its intended beneficiaries.

## **V. SUMMARY AND CONCLUSIONS**

Aid flows fell in the 1990s after the end of the Cold War and aid was widely attacked for being ineffective in spurring growth and development. However, aid began to grow again in the late 1990s and indications are that it will continue to grow throughout this decade, although probably less rapidly than donors have pledged.

Most empirical research on aid and growth conducted during the last decade has found a positive relationship, in contrast to popular perceptions, particularly studies that have allowed for diminishing returns and have controlled for other factors that affect growth. Some studies have

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<sup>13</sup> “Cutting the Red Tape,” World Bank Development News Media, February 21, 2003.

found that the aid-growth relationship is conditional on the policy or institutional environment, but many of those results have been fragile. Some studies have concluded that there is no relationship or even a negative one, but while influential these studies are few in number and tend to use restrictive assumptions. Recent research that has explored how different types of aid might have different impacts on growth has suggested one key reason why earlier research has reached mixed conclusions.

Nevertheless, there is little doubt that aid has been less effective in spurring development than is often expected. Aid can keep bad governments in power for too long, and can undermine incentives for saving, tax collection, and private sector production. Aid relationships are made much more difficult by a complex chain of principal-agent problems that weaken information flows, introduce myriad motivations for different actors, and make monitoring and accountability more difficult. Attempts to solve the principal-agent problem through conditionality have not been very successful. The newest wave of reform efforts aims to solve some of the weaknesses of aid and the principal-agent problem through greater donor selectivity in choosing aid recipients, increased recipient participation in setting priorities and designing programs, streamlining aid bureaucracies, increasing donor coordination, and establishing clearer goals for aid and stronger monitoring and evaluation of aid-financed activities. These ideas have been very influential in designing aid programs in recent years, but there is no systematic evidence at this point as to whether these changes will lead to greater aid effectiveness.

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**Table 1. Major Aid Recipients, 2004**

	<b>Total ODA (millions US\$)</b>
1. Iraq	4,658
2. Afghanistan	2,190
3. Viet Nam	1,830
4. Ethiopia	1,823
5. Congo, Dem. Rep.	1,815
6. Tanzania	1,746
7. China	1,661
8. Egypt	1,458
9. Pakistan	1,421
10. Bangladesh	1,404
	<b>Aid as % of recipient GNI</b>
1. Sao Tome & Principe	67
2. Guinea-Bissau	64
3. Micronesia	47
4. Eritrea	42
5. Timor-Leste	42
6. Marshall Islands	41
7. Burundi	39
8. Afghanistan	35
9. Sierra Leone	32
10. Malawi	31
	<b>Aid per capita (US\$)</b>
1. Nauru	1368
2. Mayotte	1226
3. Palau	978
4. Marshall Islands	852
5. Tuvalu	801
6. Micronesia, Fed. States	719
7. Cook Islands	438
8. Dominica	417
9. Palestinian Adm. Areas	337
10. Cape Verde	298

Source: OECD 2005 *Development Cooperation Report*

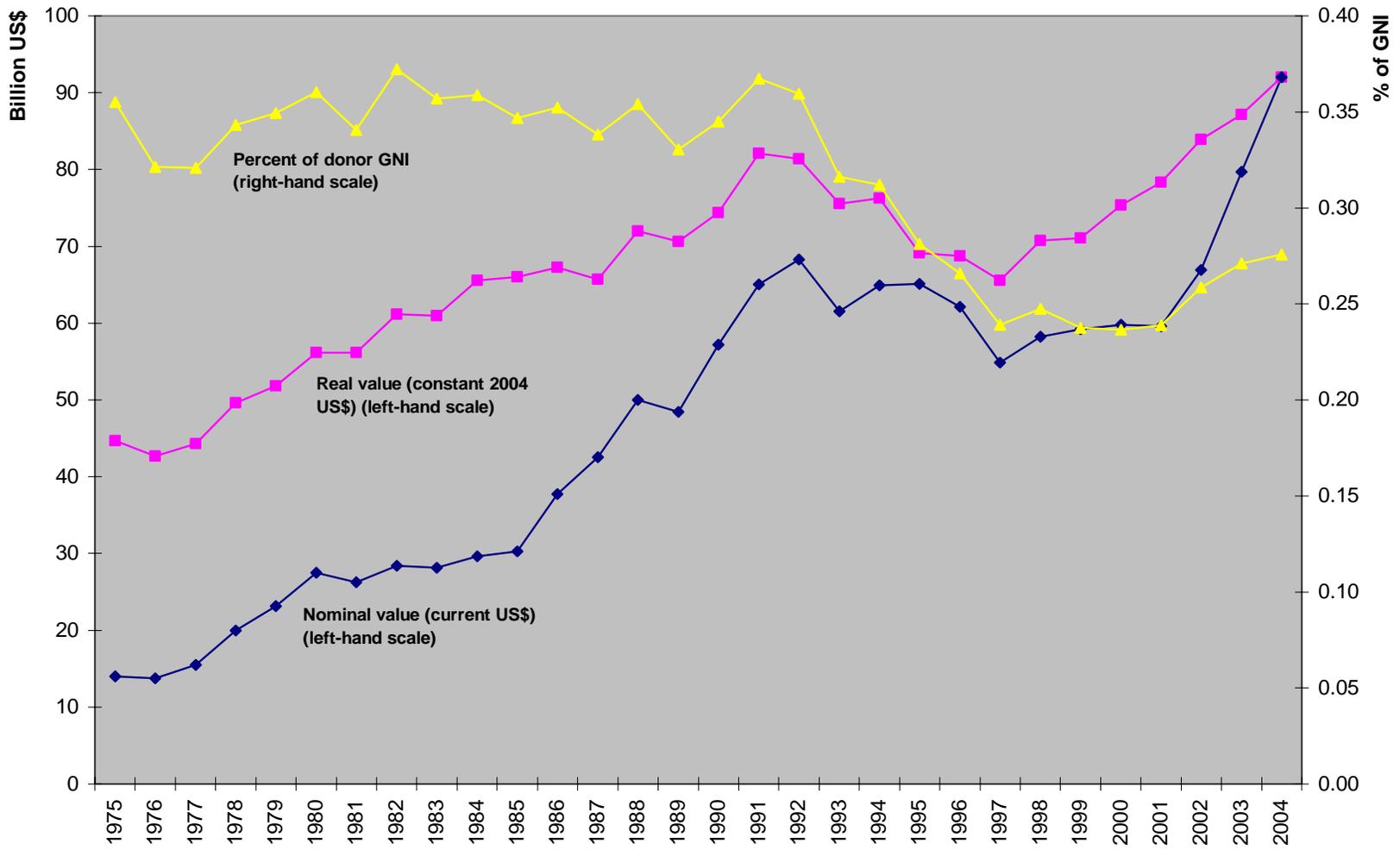
**Table 2. Official aid receipts by region, 2004**

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	<b>Billions of US\$</b>	<b>Percent of GNI</b>	<b>\$ per person</b>
Sub-Saharan Africa	26.0	5.3	35.8
South Asia	6.8	0.8	4.7
East Asia & Pacific	6.9	0.3	3.7
Europe & Central Asia	11.9	0.7	25.1
Middle East & North Africa	10.5	1.7	35.0
Latin America & Caribbean	6.9	0.4	12.6
Low income	34.0	2.8	14.5
Lower middle income	23.4	0.6	9.6
Upper middle income	6.8	0.2	11.7

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Source: World Development Indicators online



**Figure 1. Global ODA 1975-2004**

Source: OECD/DAC database

Figure 2. Foreign aid and growth, 1994-2004

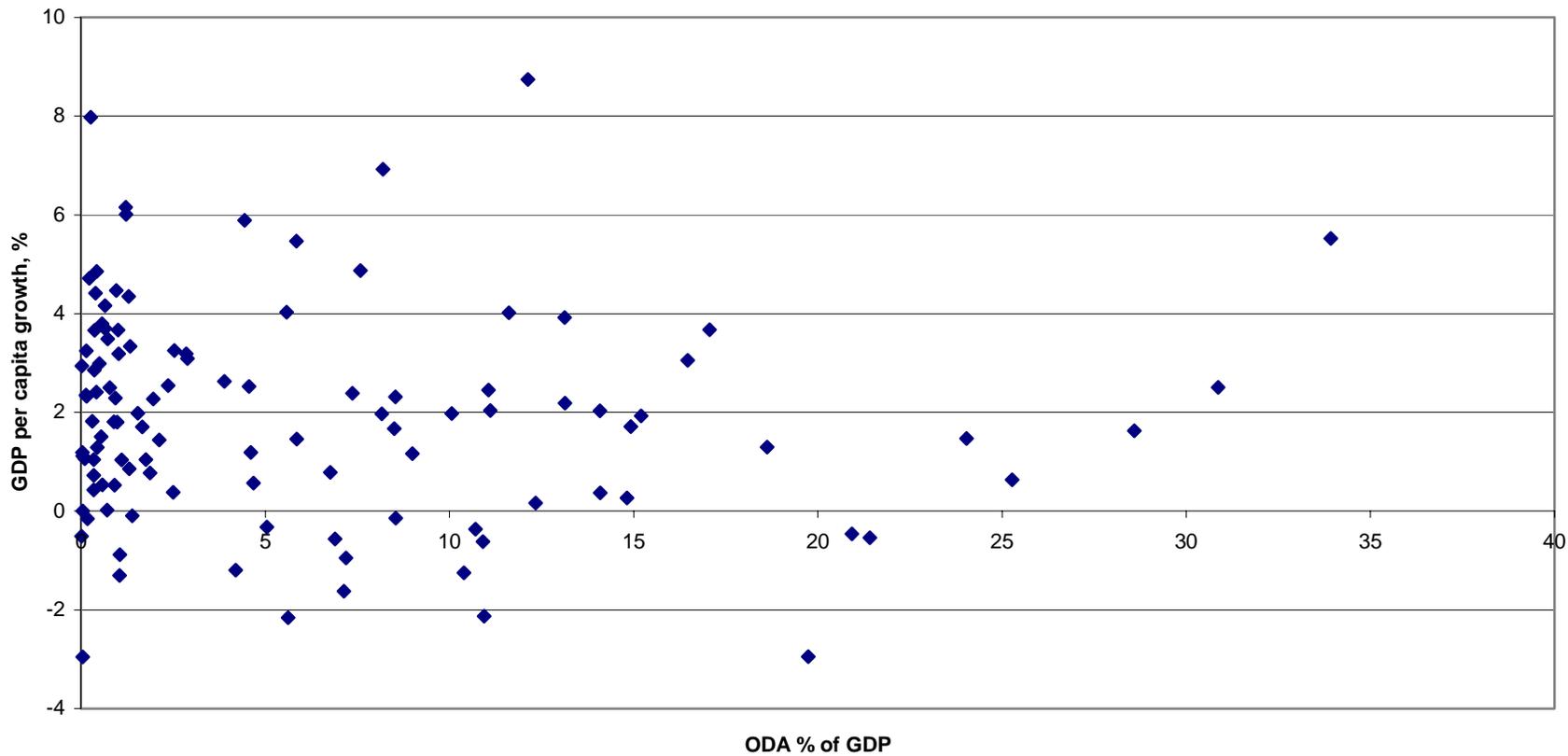


Figure 3. Three views on aid and growth.

