

Overcoming Stagnation in Aid-Dependent Countries*

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CGD Notes

Traditional economic theory predicts that capital mobility and international trade will push the world's national economies to one income level. As poorer nations race ahead, richer ones should slow down. Eventually, theory says, national economies would reach equilibrium. The reality of the last few decades, however, defies this notion; most of the poorest economies continue to lag far behind. For 50 years, foreign aid has been the main way the international community has promoted economic development. Yet it has not proven to be a silver bullet.

Why is this? What can be done? A rigorous examination of foreign aid practices shows why certain poor countries – those plagued with high poverty rates, meager economic growth and inept, corrupt leaders – remain in dire straits. This book focuses on 26 countries that vary in geography and degree of political freedom, but which share several political and economic characteristics:

- Limited legislative branch powers
- Pervasive clientelism
- Weak public institutions and non-state actors
- Small economies
- Low human development
- Few natural resources

The book argues that foreign aid *can* help pull these countries out of their economic morass, but that radical changes are needed in the way foreign aid is deployed. Despite much talk of reform, the problems that have undermined aid in the past have not been resolved. The recommendations that follow stem from an analysis of previous reform efforts.

Principles of Reform

Several broad principles should be part of any reform strategy:

- **Create the Right Incentives**
Policies that rely on exceptional leadership often are doomed to fail. For this reason, reform must aim to strengthen institutions that create incentives

to improve the behavior of individuals in donor organizations and recipient countries, even when these players are not exceptional.

- **Understand Different Purposes of Conditionality and Selectivity**

Both selectivity and conditionality should be applied to aid. On one hand, donors should enforce a simple and highly explicit form of selectivity in the political realm, while engaging in a policy dialogue with aid recipients using more traditional forms of project conditionality.

- **Donors Must Coordinate To Succeed**

In order to overcome stagnation, a majority of big donors must speak with a single voice. A promising approach would be to follow a "lead donor" model in which one donor is put in charge of a sector and is responsible for working with the recipient government.

- **Focus on Institutional Improvements**

It is nearly impossible to nurture a civil service corps, or other institutions, in countries where fiscal crises occur regularly. The best approach seems to lie in renewing attention to both economic growth and central-state capacity issues.

What to Do?

Changing the way foreign aid is given out to poor countries will not be easy. Often, reform has been stalled for lack of a powerful constituency, both in the West and in the developing world. Progress is likely to be slow and halting.

But there are approaches that can help spur political and economic change in stagnant low-income states. The book offers several ideas for overcoming stagnation.

Promote Democracy in Stagnant Low-Income States
"Strongmen" presidents who are virtually above the law tend to characterize stagnant, low-income states. On balance, evidence suggests that democracies

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outperform non-democracies. Therefore, liberal political reform that increases political participation and competition has to be part of the equation that brings economic growth and poverty alleviation to these countries.

As of the end of 2003 most stagnant low-income states have had the same leader for more than a dozen years. The book argues that donors should withdraw from countries in which the constitution does not have term limits, or in which the leader has been in power longer than 12 years.

Build a New Aid Relationship

Most relationships between donors and stagnant low-income states fail to promote the right incentives for the poor states to use aid well and promote economic development. When donors micromanage aid, they undermine the recipients' sense of ownership and self-determination. Meanwhile, much of the financial assistance to poor countries fails to reward good government performance or punish poorly performing states by taking aid away.

Donors should adopt the "Foundation Model" in which potential aid recipients approach donors with a proposal for support. The extent and nature of each individual donor country's aid programs would therefore be determined by the proposals they receive. Aid recipients should also be responsible for the evaluation of funded projects.

Build State Capacity

Incentives must be created to prod low-income states to increase their institutional capacity. One way to do this is by supporting local development experts, individuals, and civic associations that promote economic growth and democracy. In addition, donors must demand that resources given to low-income states be included in the recipient states' planning exercises and national budgets. Unfortunately, civil service commissions in many recipient countries have been weakened or eliminated due to the high degree of politicization over hiring and promotions.

Move Beyond Aid

Over the past decade, aid has been viewed as a potential instrument for attracting private investment in poor countries. Unfortunately there is a limit to private sector growth in these countries. The first priority should be aimed at strengthening reforms in the banking and

financial sectors to discourage capital flight, while repatriating funds that have already fled the countries.

The second pressing order of business is making speedier progress on debt relief. Thirdly, Western protectionism in certain sectors must be curtailed so that poor countries can compete. US subsidies for US cotton producers are a great example. Poor countries cannot afford to export cotton to US markets as a result. Meanwhile, potential Western investors in these poor countries are also deterred by such subsidies.

Finally, Western governments must improve their track record when it comes to promoting regional organizations, like the UN economic commissions, regional development banks, and various regional think tanks that are grappling with the issues in these low-income stagnant states.

Mobilize a Coalition for Change

Reform is highly unlikely to come out of donor organizations or their recipient governments. Internal and external pressures constrain the former, while clientelism and other non-developmental impulses constrain the latter.

The most potent catalyst for change is the public in these stagnant low-income states. However imperfect, political liberalization can allow for the emergence of a livelier press, robust civil society, and better-educated politicians. The West can assist these countries by nurturing the fledgling democratic spaces where more accountable and development-minded governments can flourish.

As a potential changemaker, the Western NGO community also holds much promise. In the last decade they have proven successful influencing donors with respect to the environment, poverty reduction, donor conditionality, and debt relief. Most of the Western NGO community's focus has been on substantive issues rather than procedural issues and aid modalities. Still, NGOs could be a powerful force for change by pushing for greater donor coordination and by being more vocal about governance failure in recipient nations.

Finally, the private sector also has its role to play. As a way to limit corruption, private companies could promote the idea of "revenue transparency" and be more accountable as to how money is being spent in these countries.