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Are the planned increases in aid too much of a good thing?

By Owen Barder

Abstract

Donor countries have committed themselves to increase aid to developing countries by 60 percent over the next five years; and larger increases would be needed to meet the Millennium Development Goals (MDGs). But there are concerns that there may be a limit on the amount of aid that developing countries can absorb and use effectively—and that large aid flows might even be harmful. Could a large increase in aid be "too much of a good thing?" This essay disentangles the seven possible reasons why additional aid might not be effective. These include microeconomic effects (*e.g.,* transactions costs), macroeconomic effects (*e.g.,* 'Dutch Disease') and the impact on political economy (*e.g.,* the 'Resource Curse'). The paper looks at each possible constraint in turn. The paper finds that there are indeed serious obstacles to effective use of increased aid, but that none is immutable. All of the constraints which limit the effective use of additional aid can be addressed by a relatively small set of practical improvements in the way that aid is provided and used. Donors have already committed themselves to a significant program of aid reform. If the measures to which donors are committed were consistently implemented, the seven constraints to effective aid absorption could be relaxed. The paper concludes that, provided increased aid is accompanied by reforms to the way aid is delivered, the capacity of developing countries to absorb and use aid should not be presented as a barrier to the increases in aid which would be needed to meet the MDGs.

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"The King of Darknesse, yeeld t' his powrefull plea.
Among the late-come Soules, Euridice
They call: she came; yet halting of her wound.
Given Orpheus, with this law: Till thou the bound
Of pale Auernus passe, if back thou cast
Thy carefull eyes, thou loosest what thou hast."

George Sandys
Ovid's Metamorphosis
1632

Summary[1]

Aid to developing countries would increase by more than 60 percent over the next five years if the international community meets its commitments. But there are concerns about whether an increase in aid of this size can be used effectively. Is there a limit to the amount of aid that can be absorbed? Might more aid be "too much of a good thing"?

Looking at these concerns in more detail, the problems identified as limits on "aid absorption" are in fact a quite diverse set of challenges. This paper groups the obstacles to aid absorption into seven distinct constraints, each of which has been identified as a possible reason why the costs of aid might rise more quickly than the benefits:

Box 1: Seven constraints on the effective use of more aid

(a) Microeconomic

1. Transactions costs
2. Bottlenecks (e.g. shortages of skilled people)
3. Diminishing marginal returns

(b) Macroeconomic

4. Macroeconomic effects of sustained aid inflows (Dutch Disease)
5. Macroeconomic effects of short-term volatility in aid

(c) Political economy

6. Corrosion of accountability of governments ("who pays the piper")
7. The resource curse

If these constraints mean that the costs of aid to the recipient become more significant relative to the benefits when aid increases, then there could be an upper limit on the amount of aid that can be used effectively. If, however, the costs of aid do not rise disproportionately, or if the problems can be alleviated by changing the way that aid is given, then increased levels of aid can, in principle, be absorbed and used effectively.

Considering these possible constraints in turn, the paper concludes that:

a. These are indeed valid concerns which taken together constitute a challenge to the ability of developing countries to make effective use of substantial increases in aid.

b. However, none of these constraints is immutable; each is the consequence of inefficiencies in the aid system, many of which are within the control of donors. They do not imply a fixed upper limit on the amount of aid that could be given and well used.

[1] Thanks especially to Steve Radelet for his guidance and wisdom. Also thanks to Nancy Birdsall, Michael Clemens, Dennis de Tray, Mick Foster, Ruth Levine, Todd Moss, Gunilla Pettersson, David Roodman, Celina Schocken and Adrian Wood for helpful contributions and comments on earlier drafts. Any remaining errors and opinions are, of course, my own.

c. A small number of practical changes to the aid system would relax these constraints to enable additional aid to be more effectively used. Donors have already committed themselves to making many of these changes, though progress has been slow.

d. Although there are possible costs as well as benefits to receiving aid, these costs do not generally rise disproportionately as aid increases, and so aid would not generally become less effective on average as it is increased.

e. In addition to providing more aid to the poorest countries, there is scope for very large increases in aid to be used well to ensure the provision of global public goods.

This analysis should not be understood as suggesting that there are no other challenges to solve if the international community is serious about meeting the Millennium Development Goals. But it does imply that donors and recipients can work together to relax the constraints which limit the effectiveness of additional aid.

The expected increases in aid

A number of studies have argued that development aid would need to double to meet the Millennium Development Goals (MDGs) (e.g. Zedillo Panel 2001, Devarajan *et. al.* 2002). The UN Millennium Project (UNDP 2005) estimated that aid would need to rise from $79 billion in 2004 to $195 billion by 2015. This would increase aid from 0.25% of GDP in donor countries in 2005 to about 0.54% by 2015. In 2005, the Commission for Africa, chaired by UK Prime Minister Tony Blair, called for aid to Africa to be increased from $25 billion a year in 2004 to $50 billion a year by 2010, and for a further increase of $25 billion by 2015 (Commission for Africa 2005).

These studies do not show – nor do they claim – that increased aid is a sufficient condition for developing countries to reach the MDGs. What they imply is that, if the policy reforms and institutional changes are made which would permit countries to meet the MDGs, then additional aid flows of this scale are needed to finance this level of services. In other words, these analyses suggest that increased aid is a necessary, but not a sufficient, condition of meeting the MDGs.

Donors have responded to these calls with promises of future increases in aid. In the context of the United Nations Financing for Development Conference in Monterrey in 2002 there were pledges of increases in aid from the United States of $5 billion a year by 2005, and from the European Union (EU) of increases to 0.39% of GNP by 2006. In May 2005 the EU countries went further, announcing that they would reach 0.56% percent of GNP by 2010 and 0.7% of GDP by 2015 (EU 2006). For the G8 Gleneagles Summit in 2005, the G8 and other donors pledged to increase aid by $50 billion a year by 2010, with half of the additional aid going to Africa. On current commitments, aid will rise to about $128 billion in 2010, an increase of more than 60% over the level in 2004 (OECD DAC 2006).

It is useful to distinguish at least four possible purposes of aid, which apply differently in different contexts:

- to mitigate economic shocks; this aid needs to be available quickly, with little bureaucracy and few strings attached;

- ❖ to generate and transfer knowledge, especially to improve the provision of public services and government policy over time; this requires diversity in approaches to test new approaches, and effective systems for evaluation and knowledge sharing;

- ❖ to fund the delivery of global and regional public goods, especially those which benefit people in poor countries and in which there would otherwise be too little investment;

- ❖ to transfer resources to very poor countries over the long term, mainly to enable government to supplement small domestic revenues to enable them to deliver basic public services and provide national public goods, such as infrastructure; and to create an environment in which economic growth and improvements in human development can occur; on some analyses, this aid is needed to help countries to lift themselves out of a "poverty trap".

The debate about whether developing countries can absorb substantially more aid, and hence this analysis, revolves around the last of these four objectives: the use of aid to support basic services and economic growth in very poor countries (though the paper also discusses the use of aid to fund public goods).

Is aid less effective at higher levels?

This paper is not primarily about the effectiveness of existing levels of aid, or how aid could be improved. This analysis takes as its point of departure that there is good, though not conclusive, evidence that aid at its present levels is beneficial for developing countries. This is based in part on a body of evidence which suggests that, aid at current levels is positively associated with economic growth. In particular, Clemens *et al.* (2004) provide an analysis based on disaggregated data on aid commitments to estimate the economic growth effects of aid. They identify aid that is intended to affect economic growth within four years, and exclude expenditure which is not intended to impact directly on economic growth in the short term, such as emergency relief, support for democratic institutions, and spending on the environment or education (these may have long-run effects on growth, but are unlikely to be observable in the short run). They find that the remaining aid has a robust positive effect on economic growth in the recipient countries. These results are consistent with the conclusion of the majority of studies of the relationship between aid and economic growth (see McGillivray, 2004 for a survey).

Furthermore, in addition to these aid-growth studies there is considerable evidence suggesting high rates of return using micro-evidence from specific projects and programs (see Levine *et al*, 2004 for examples in global health).

But even if it is accepted that aid has, on average, positive effects at its current levels, it does not follow that aid would be remain effective if it were increased by the 60% that is currently proposed. It is possible that this additional aid could have little or no additional benefit, or even that at high levels it could be harmful for the recipients.

Broadly speaking estimates of the relationship between aid and economic growth divide into two camps. A minority of these studies test the hypothesis that there is a linear relationship between aid and growth.[2] These studies generally find that there is no relationship. Other estimates of the relationship between aid

[2] Boone (1996), Rajan & Subramanian (2005b).

and growth include quadratic or logarithmic aid terms, in order to account for the possibility of diminishing (or increasing) marginal returns. These studies generally find that there is a positive relationship between aid and growth, but also that there are diminishing marginal returns.

Of course, there are many technical difficulties in establishing a statistical relationship between aid and economic growth, and great caution should be exercise to avoid placing more weight on the estimates than they will bear. Nonetheless, the empirical literature suggests that, if there is a positive relationship between aid and growth, it is one that is currently characterized by diminishing marginal returns.

Michael Clemens and Steven Radelet (2003) survey the literature on the empirical relationship between aid and growth. These estimates enable projections to be made of the point at which marginal returns would diminish to zero, which Clemens and Radelet call the “saturation point”. They find that, with current and past institutions for aid, the implied saturation points in aid-growth models range from 15% to 45% of recipient GDP. In their own aid-growth regressions, Clemens et al (2004) find evidence that marginal returns to aid may fall to zero at about 17% of GDP in the average country, with some variation above and below this point.

Aid to sub-Saharan Africa was about 5.7% of GDP in 2003, or 11.7% excluding South Africa and Nigeria. Half of the 46 countries in sub-Saharan Africa currently receive aid of more than 10% of GDP, and 11 countries receive more than 20% (Moss *et. al*, 2005). If aid to sub-Saharan Africa doubles, as the G8 agreed in Gleneagles in 2005, it could in principle approach or surpass some of the lower estimates of the aid saturation point. However, these empirical estimates are based on observations of aid well below the hypothetical point at which marginal returns are projected to fall to zero. There are no direct observations on which to calibrate empirical estimates of the point at which aid becomes too much of a good thing.

More importantly, these estimates are a measurement of the effect of aid in the *status quo* in which the effectiveness of aid is hampered by existing constraints. They do not allow for the possible improvements in aid, and hence the relaxation of the constraints, which are discussed in this paper.

CONSTRAINTS ON THE EFFECTIVENESS OF INCREASED AID

The discussion below considers seven different possible reasons that have been given, in various combinations and with different emphasis, by different authors to explain why there might be diminishing marginal returns to aid, and why large volumes of aid might be damaging to the recipient. The purpose is to examine each constraint in turn to see how it might operate to reduce the overall benefits of aid, and what might be done about it.

There is an important distinction between those inefficiencies which reduce the effectiveness of aid at any level, but which rise no more quickly than the benefits of aid, and those inefficiencies which grow disproportionately as aid increases. The former group would reduce the average effectiveness of all aid, but they do not lead to diminishing marginal returns. It is the second group - those costs that rise disproportionately as aid increases – which might give rise to diminishing (or even negative) marginal returns from aid.

If there are valid concerns about the ability of developing countries to use increased aid effectively, the challenge is then to determine whether there are steps that could be taken to reduce or eliminate the effects which give rise to diminishing returns, and/or to increase the average effectiveness of aid. Taken together, such measures would push out the "saturation point" at which aid is no longer of value to the recipient.

MICROECONOMIC CONSTRAINTS

1. Increases in transactions costs for recipient governments

1.1 The problem

Administrative requirements can impose a considerable burden on recipient countries and use scarce administrative resources. In the typical African country, aid is provided by *"some thirty official donors in addition to several dozen international NGOs…through over a thousand distinct projects and several hundred resident foreign experts"* (van de Walle 1991). Van de Walle and Johnston (1996) reported roughly 60 active donors and 600 ongoing projects each in Kenya and Zambia in the mid-1980s, and some 40 donors and 2,000 aid projects in Tanzania in the mid-1990s. Starting from a hypothetical project count of 600, they suggest that recipient governments typically file 2,400 quarterly reports to donors and host 1,000 missions from donor officials to monitor project activities. These two numbers were subsequently quoted by the then President of the World Bank and misinterpreted as a fact about Tanzania, leading to the urban legend that Tanzania had to file 2,400 reports and host 1,000 missions each year (Roodman, 2006a).

We do not have a reliable estimate of the total costs of these requirements, but in aggregate it is clear that they impose substantial costs on the recipient, and so reduce the average benefit of the aid. These transactions costs are amplified by diverse donor rules and procedures for managing aid projects and programs, conflicting agendas, and the high costs of appraisal, monitoring and reporting. (See Berg, 1993, Brautigam & Knack 2004, Birdsall 2004, van de Walle, 2005, Moss, Pettersson & van de Walle 2006). Furthermore, aid is more volatile than domestic revenues (Bulir and Lane 2002) and the consequent fiscal uncertainty makes long term planning extremely difficult, greatly reducing the scope for efficient use of aid resources (Heller and Gupta 2002).

Many of these transactions costs diminish the average effectiveness of aid, but most are not proportionately worse in highly aid-dependant countries.[3] These transactions costs should evidently be reduced if possible, but if they grow in proportion to aid they do not constitute a reason to avoid further increases in aid.

But some transactions costs could rise more than proportionately as aid increases, and could therefore lead to diminishing marginal returns. An example is the hiring (or, more pejoratively, "poaching") of skilled staff. For example, in the early 1990s, a World Bank project hired Kenyan advisors, mostly from other government ministries, into the Ministry of Agriculture and Livestock Development, at salaries of between $3,000 and $6,000 a month, compared with a total compensation package of approximately $250 available to a senior economist in the civil service (Wilson, 1993; quoted in Knack & Rahman, 2004). If an increasing number of project management offices hire from a small pool of competent local administrators, there may come a point at which wages are pushed up, or a finite supply of competent administrators is exhausted, so reducing the government's ability to administer its programs (Brautigam & Knack, 2004).

[3] In other words, they do not give rise to diminishing marginal effectiveness.

1.2 Can the constraint be relaxed?

These transactions costs are generally the result of administrative arrangements which are intended by donors both to increase the effectiveness of the aid projects, and to enable donors to demonstrate that aid has been used effectively and for the purposes intended. Paradoxically, the mechanisms may have the opposite effect if they increase transactions costs and so make aid less effective.

These administrative costs could be reduced in relatively straightforward ways. In those countries in which standards of governance and accountability are sufficiently strong to warrant substantial increases in aid, donors can reduce transactions costs by:

- Limit project proliferation by increasing average project size, scale up existing successful projects with high returns to scale (Roodman 2006b).
- In countries that are demonstrably committed to poverty reduction, use the recipient's own systems for prioritizing, budgeting, procurement, accounting and auditing, even though these systems are likely to be imperfect.
- Be explicit about spillover effects when designing appraising projects (such as administrative burdens, skills constraints), for example by appraising the impact on a sector of the Poverty Reduction Strategy rather than appraising only the effects attributable to individual projects.
- Rely on a few key measures of results – in the form of outcomes – rather than inputs or intermediate outputs.

In summary, few of these transactions costs give rise to diminishing marginal returns; and donors could make changes in the way that aid is delivered that would significantly reduce these transactions costs.

2. Bottlenecks (e.g. skills shortages)

2.1 The problem

Many developing countries have limited skilled labor in the short run. This means that they may not be able to make effective use of resources provided as aid. For example, it will benefit a country little to be given essential drugs if the country is unable to provide the necessary skilled medical professionals to make diagnoses or to administer those medicines. Using aid effectively generally requires a range of complementary inputs to be available, of which the input often considered most likely to be constrained is skilled labor.

If there are bottlenecks of this sort, then additional aid will result in substantially smaller benefits on average than existing aid, and so there will be diminishing marginal returns.

2.2 Can the constraint be relaxed?

While aid can result in bottlenecks of crucial resources – especially skilled people – it can also be used to relieve the constraints, by investing in training to increase the supply of the skills that are in short supply.

Consider the case of programs to prevent and treat HIV/AIDS. In 1987, total donor spending on HIV/AIDS was around $50 million a year. At that time, there were few doctors or nurses trained to diagnose and treat HIV; there were few professionals trained to mount public awareness campaigns; and there was no infrastructure to market condoms. Since, then, with the support of donors, governments have scaled up their capacity to implement broad programs to raise awareness of HIV, encourage changes in behavior, provide access to condoms, diagnose the medical condition of patients, and supervise highly complicated anti-retroviral treatment regimens. By 1996, donor spending on HIV/AIDS had risen six-fold to $300m; and by 2006 it had reached about $8,900 million (UNAIDS 2005).

Twenty years ago, it would have been correct to argue that these countries lacked the skills and capacity to make effective use of substantial increases in spending on HIV/AIDS. And yet since then, donors increased spending six-fold over ten years, and then increased spending a further thirty-fold over the following ten years, making a total 180-fold increase (UNAIDS 2005).

This example shows that the supply of skilled labor is endogenous, at least in the medium term. Aid can be used to build capacity directly, and to supplement the resources of the partner country so that it can expand its own training centers and increase its trainers. In general, bottlenecks such as lack of skilled labor can be removed if there is sufficient political will, if aid is predictable, and scaling up is properly planned to address those bottlenecks at the outset. (Of course, this does not always happen as it should.)

Donors can help to ensure that aid is used to lift constraints, rather than running into them, if they:

- Minimize the earmarking of resources, so that recipients can use them to ensure that the necessary complementary inputs are available.
- Improve technical assistance and training programs to reduce the constraints on skilled labor (this is a long-overdue agenda; see Berg, 1993).
- Allow aid to be used flexibly to hire necessary skills in short supply from within the country, region or internationally.
- Provide long-term, predictable aid which recipients can develop long-term strategies to build up capacity. Recipients cannot invest in improved institutions, train public servants, or recruit higher caliber staff, on the basis of budgets that vary unpredictably from one year to the next.

As the example of scaling up programs to tackle HIV/AIDS shows, aid resources can be used to lift the constraint of skills bottlenecks, if the aid partners focus on enabling some of the additional resources to be used to support long-term investments in institutions, skills and knowledge sharing. However, the process of using aid to lift constraints – for example, by increasing the supply of skilled labor – may take a long time and it requires predictable and long-term resources.

3. Diminishing marginal returns to investment in growth

3.1 The problem

Economists generally assume that investment and production are subject to diminishing marginal returns. This is particularly likely when one factor of production is increased when another is fixed. A common example in the context of aid is that skilled labor may be in limited supply in the short and perhaps medium run. As aid increases, the limited number of skilled people to use the resources becomes a constraint on how well it can be used. The problem of fixed inputs which are needed to complement aid, and how this possible constraint can be relaxed, was the subject of section 2 above.

But diminishing returns can also occur because the most productive investments are likely to be implemented first. As resources are increased, the next-best investments (by definition) offer smaller returns than the highest priorities. This effect has nothing to do with costs of receiving aid: it is just that the best projects are chosen first. This ranking effect could give rise to diminishing returns even in the absence of finite factors of production. However, this would only produce a marked fall-off in the returns to aid to the extent that increases in aid from its current levels would lead to investment in activities of significantly lower value than current aid programs. Given the very large number of activities with very high rates of return that currently do not receive funding because resources are scarce, this effect is unlikely to be observed in practice.

Furthermore traditional models of economic growth have evolved in the last two decades to take account of the importance to knowledge and the accumulation of human capital in driving economic growth. And knowledge has a special characteristic: increasing returns to scale (Romer, 1986). Knowledge may be expensive to create, but it cost virtually nothing to provide knowledge to additional users. If economic growth depends on increases in knowledge, and if the acquisition and use of knowledge is a self-reinforcing, endogenous process, then instead of diminishing marginal returns there will be increasing marginal returns to investment in knowledge transfer. To the extent that aid is used to facilitate and accelerate the transfer of ideas and knowledge, these endogenous growth theories suggest that it might generate increasing rather than diminishing returns.

There are other possible reasons for increasing returns and threshold effects in aid, particularly where there is complementarity across aid projects. Jeff Sachs gives the example of a road with half of the road paved and half impassable due to missing bridges or washed out sections. Repairing the impassable sections would double the length of road, but would much more than double the output from the road. "*This is an example of a threshold effect, in which the capital stock becomes useful only when it meets a minimum standard.*" (Sachs 2005; see critique in Easterly 2005). The value of investments in improving capacity in health care is increased if there are complementary investments in rural roads which enable people to travel to clinics, or if improvements in water supply reduce the time spent fetching water and enable mothers to take children to be immunized. A more reliable power supply may not be enough on its own to encourage business investment, but if this is accompanied by a reduction in corruption at the ports and more reliable telecommunications, together these policies might improve the climate for investment.

So overall, modern growth theory does not tell us whether the positive effects of increasing returns through endogenous growth effects and complementarity of investment are outweighed by more traditional assumptions of diminishing marginal returns. Empirically, it is true (as set out above) that there is empirical evidence of diminishing marginal benefits of aid as under current arrangements; but these are the result of the combined effect of all the constraints on the effectiveness of aid described in this paper. That evidence does not, of itself, confirm the existence of the diminishing marginal returns described in this section. Leaving aside limits to one or more factor of production (discussed in 2 above) it is quite possible that the marginal effectiveness of aid projects would actually increase as their number grows, especially if interventions are mutually reinforcing and complementary, or if there are increasing returns to scale in the determinants of growth, for example in the sharing and use of knowledge.

3.2 Can the constraint be relaxed?

If donors and aid recipients are concerned that rates of return could fall as they extend the portfolio of aid projects, they can offset this risk:

- Concentrate on scaling up projects that are a proven success, which do not exhibit diseconomies of scale and which are currently limited by lack of resources such as immunization; (this point is made by Roodman, 2006a).
- Make better use of evaluation to identify the most productive investments.
- Invest as part of the government's overall poverty reduction strategy so that interventions are mutually reinforcing and yield the maximum possible positive spillovers between projects.
- Ensuring that aid is as effectively spent as possible, for example by untying aid from particular suppliers; Jepma (1991) found that tying aid to the employment of donor country contractors reduces its value by between 15 percent and 30 percent.

(b) MACROECONOMIC CONSTRAINTS

4. Long-run effects of sustained aid inflows (Dutch Disease)

4.1 The problem

A large, sustained increase in aid may lead to a shift of production from tradable goods and services (such as food or textiles), towards non-tradable goods and services (such as teaching or health care, known as non-tradables). Because this effect on the country's real exchange rate is similar to the impact of the discovery of a natural resource, it is often known as "Dutch Disease".[4]

To understand why this happens, bear in mind that aid benefits the recipient because it enables the country to increase imports without having to sell exports of an equivalent value. The recipient may use some aid to buy additional imports of goods and services that could not have been afforded otherwise – for example vaccines, fertilizer or equipment. But the recipient may also use aid to pay for its existing imports, enabling it to shift domestic production from exports to domestically used goods and services (*e.g.* teachers or health care). Overall, this is a benefit to the recipient the country can reduce the amount of its own resources it has to devote to exports by instead using aid to pay for the imports that it needs.

This shift in domestic production from tradable goods to non-tradable goods occurs in a market economy through a change in relative prices. Wages and prices increase in the non-tradable sector to attract more people to train as nurses or teachers, and relative wages and prices fall in the tradable sector. This change in relative prices (which economists call an appreciation of the "real exchange rate") reduces the international competitiveness of tradables; and it triggers the change in the composition of domestic output that enables the country to make use of the aid to increase the production of non-tradables.

Some analysts (e.g.Heller 2005, Rajan and Subramanian 2005) have argued that this Dutch Disease effect adversely affects the competitiveness of exports, and that it could reduce overall economic growth and so undermine the overall effectiveness of aid.

[4] The term was coined in the article "The Dutch Disease" (November 28, 1977). *The Economist*, p. 82-83.

These issues are discussed in more detail in Barder (2006). If aid is permanently increased, and this results in a shift of production from tradables to non-tradables, this is not directly a cause for concern, at least in the short run. The immediate value of exports is that they pay for imports. If exports can be reduced in the long run with no corresponding fall in imports – because permanently higher levels of aid pay for those imports instead – then as a matter of accounting, the country is better off. This shift in output would be problematic only if the fall in tradable production were to lead to a sustained fall in future economic growth.

There are reasons to be concerned that this change in the composition of output from tradables to non-tradables could indeed lead to lower growth in the long run. Openness to trade is an important determinant of economic growth: the history of poverty reduction in the twentieth century has been primarily one of export-led growth. The broad, long-term growth benefits from trade include the competitive pressure of having to meet the standards of international markets, the transfer of ideas and technology from abroad, and access to intermediate goods which enhance the nation's productivity. However, there is a good deal of uncertainty about the precise channels by which trade has a positive impact on growth. There are many benefits from exports – particularly on raising productivity in the export sector by having to compete in world markets and the benefits of international investment for production for export. There are also many benefits from imports, including increased competition for domestic producers, the import of intermediate goods, and the use of knowledge and ideas gained from imported goods and services.

Since aid leads to a rise in imports as well as a shift away from tradable production and a possible fall exports, it is far from clear how this will affect overall economic growth. The increase in imports may increase growth of productivity and output, while the fall in exports is likely to do the reverse. Overall, the total impact on growth of these offsetting effects might be quite small.

This does not imply any disagreement with the prevailing wisdom that openness to trade and export-led growth play a vital role in the development process. The point is to resist a simplistic analogy between the significant harm that can be done by policies which restrict openness and restrain the growth of trade, and the consequences of a one-off contraction of tradables caused by Dutch Disease. In contrast to broader restrictions on a country's ability to export, the effect of aid is an *increase* in the country's capacity to import, from which some of the benefits of openness are likely to come; and the effect of the aid through the real exchange rate is a short-term contraction in tradable output, not a barrier to the future growth of exports.

Furthermore, if there were an adverse demand effect on growth resulting from Dutch Disease, this could be offset by the supply-side benefits of using the aid. Some aid will be invested in ways which increase the nation's productivity – for example, by improving the transport infrastructure, increasing the reliability of power, reforming government institutions, increasing skills, improving public health or simply lowering domestic taxes. To the extent that these investments are successful, then over time this increase in productivity – including in the tradables sector – will offset the adverse impact on firms' competitiveness caused by the Dutch Disease effect. This productivity effect may be particularly strong if aid is targeted at reducing the impact of specific bottlenecks.

Model estimates (Adam and Bevan, 2004) find that if there are modest supply side benefits from aid, these are likely to be sufficient to offset any possible adverse effects on economic growth. This finding is consistent with the empirical evidence which shows a positive correlation between aid and economic growth.

The final reason to be more optimistic about the macroeconomic impact of a sustained increase in aid is that increasing output in the long run is only one part of the purpose and benefit of aid. As well as increasing growth, aid is also intended to enables the citizens of a country to live better in the meantime. How citizens live is a product of the average level of consumption and investment in the country; and aid permits consumption and investment to be higher than the country's output. Even if output did fall slightly in the short run as a result of Dutch Disease, the increase in consumption and investment permitted by the aid is substantially larger than any possible fall in output. Even with Dutch Disease, the additional consumption and investment that aid finances enable the citizens of a country, on average, to live better than they would without the aid.

As discussed in the next section, Dutch Disease may be problem for the management of *surges* in aid which may pose significant challenges for export-led growth. But for a *sustained* increase in aid using aid to increase productivity is likely to offset any adverse effects on growth caused by Dutch Disease; and consumption and investment will be higher as a result of aid even if there were an adverse effect on output.

There is a further possible challenge for aid recipient countries, which is that the demand for government services may reduce the supply of skilled labor to the private sector, which is the main engine of economic growth. Kochhar *et al* (2006) find that the evolution of manufacturing in India may have been affected by the intense demand for skills in services which has raised wages, attracted creative and inventive managers from manufacturing to services, and reduced growth in labor-intensive and tradable manufacturing. This is neither entirely a macroeconomic nor microeconomic phenomenon, but in view of the parallel with Dutch Disease, Kochhar *et al* dub this effect the '*Bangalore Bug'*. In India's case the Bangalore Bug is not caused by aid, but there could be similar effects in aid dependent countries if aid distorts demand and attracts skills towards government services away from job creation and enterprise in the private sector.

4.3 Can the constraint be relaxed?

We should not be complacent about the possibility of macroeconomic effects leading to a reduction in the competitiveness of exporters, or the possible human consequences of a shift in the composition of domestic production towards non-tradables. The possible adverse macroeconomic effects of a sustained increase in aid can be minimized if:

- donors and recipients arrange for some of the aid to be spent on imported goods and services which do not substitute for domestic production, such as vaccines, which have no impact on the real exchange rate;

- donors and recipients encourage aid to be used to make investments that will increase productivity in the short run – for example, tackling infrastructure bottlenecks, improving communications or power generation;

- donors provide predictable, long-term aid so that investments to improve productivity can be planned and implemented to offset the adverse impact on the tradable sector.

There is a separate set of issues for macroeconomic management caused by temporary or volatile increases in aid, which are considered in the section below. Overall, the Dutch Disease effects of a sustained increase in aid, such as is envisaged in the context of increasing long term aid as part of meeting the Millennium Development Goals, can be managed, especially if some of the aid is used to contribute to the long run growth of productivity.

5. Short-run macroeconomic effects of volatile aid flows

5.1 The problem

The previous section discussed the effect of a sustained increase on aid on the composition of domestic production and the possible impact on long-run economic growth. This section considers the possible impact of a surge in aid that is not sustained. In this case, the recipient country faces the possibility of the worst of all worlds:

- a temporary loss of firms' competitiveness, caused by the appreciation of the real exchange rate that accompanies the aid inflow, leading to loss of sales contracts, job losses and possibly business closures;

- but without the long term benefits from higher consumption and investment funded by sustained aid;

- and without the productivity or other economic benefits resulting from investments financed by the additional aid;

- with substantial transitional costs for workers and investors as the economy shifts first in one direction and then in the other.

In the case of temporary (rather than sustained) increases in aid, it is quite plausible that these macroeconomic costs could exceed the benefits of the aid (see Heller 2005, Foster & Killick 2006, IMF 2005).

5.2 Can the constraint be relaxed?

This problem of short-term macroeconomic effects can be solved by improving the way that aid is given. Donors can reduce these costs if they:

- make aid less volatile, so that any increases in aid are likely to be sustained;

- make aid more predictable, so that monetary authorities can take the necessary steps to choose how much of the impact on exchange rates they wish to sterilize;

- allow recipient countries to save some of the aid (in the form of higher reserves) rather than spend it, so that they can smooth the domestic expenditure which causes the real exchange rate appreciation;

- allow recipients to use temporary aid inflows largely on imported goods, such as essential medicines;

- eschew additionality requirements, which require recipients to demonstrate that aid has been used to increase total expenditure in a particular sector, to enable recipients to manage the overall macroeconomic effect of aid inflows.

Perhaps more than any other challenge to aid absorption, the macroeconomic consequence of aid inflows make it *essential* that aid should be more stable and more predictable. Large and sustained increases in aid can be accommodated without doing harm to the recipient; volatile aid inflows may well do more harm than good.

Of course, as countries grow, the aid they receive will be reduced and eventually countries should graduate from aid altogether. In the case of the very poorest countries, this may not be realistic for many years to come. Provided this is a gradual, predictable reduction in aid, offset by rising domestic productivity and output, this will not lead to the macroeconomic uncertainty and transitional costs described here. The appreciated real exchange rate will come to reflect, over time, the rising level of domestic productivity rather than the declining volume of aid.

Predictability is not quite the same as stability. If aid is to be linked to results, and to the continued progress of recipient governments towards greater accountability and higher standards of governance, levels of aid will in practice need to change over time to reflect progress that is being made, and to ensure that aid is being spent in countries in which it can be most effectively used. But these considerations about aid volumes should not be allowed to give rise to unpredictable aid flows. Donors should make long term judgments about the commitment of partner governments and their direction of travel: the laudable aim of linking aid to performance does not constitute a good reason to make decisions that cause short-term volatility in aid. Aid volumes can and should change over time to reflect performance, but if the relationship between policy performance and aid volumes is transparent, predictable and based on long-term developments, then aid volumes will evolve as a foreseeable consequence of the long-term evolution of the policy environment and performance. In these circumstances, aid volumes should be predictable, though they would not be constant over time.

(c) POLITICAL ECONOMY

As well as microeconomic and macroeconomic concerns about the impact of aid, a literature has emerged in recent years that discusses the impact on the governance and accountability of aid recipients.

It is convenient to divide the problem into two related (and not completely distinct) themes. The first theme is that donor behavior may corrode domestic accountability mechanisms because the aid relationship – especially conditionality – requires recipient governments to respond to the priorities of donors rather than domestic constituencies. The second theme is an aid version of the "resource curse" – that is, that danger that governments that receive aid will raise smaller revenues from their own population and thereby weaken the social contract between government and citizens.

6. Corrosion of accountability

6.1 The problem

Governments in well-functioning democracies are answerable to their citizens through mechanisms of parliaments, civil society and the media. But in aid-dependant countries, donors impose conditions on recipient governments. Some of these conditions lay down how the aid should be used; others specify broader policies or institutional changes that the recipient must pursue in order to continue to receive aid. As discussed in Moss, Pettersson and de Walle (2006), these conditions can have a pernicious effect on the accountability of governments to their citizens:

- governments defend their decisions as the unavoidable consequence of donor conditions, reducing clarity about what they can and should be accountable for;

- citizens who believe that that their leaders must respond to pressure from donors will spend less time and effort pressing their demands on the local legislature and executive.

Some donors claim that it is a benefit of conditionality that it shields reform-minded ministers by enabling them to "blame the donors" for unpopular but necessary changes. This justification implicitly recognizes (and seeks to make a virtue of) the reality that conditionality reduces, at least to some extent, the accountability of governments to their own domestic stakeholders.

In most egregious cases of highly aid-dependent countries, donors may behave as if they were the official opposition party. Donor groups analyze government programs, form a position, debate the merits of the policy both privately and publicly, and make public and private threats about their response in the face of government policy proposals.

Donors can also have the perverse effect of reducing accountability by enabling line ministries to obtain resources in the form of projects and sector funding which releases ministers from the disciplines of the budget process. Neither the Parliament nor the Cabinet and Finance Ministry can effectively prioritize government spending or hold ministers to account for their performance if a substantial amount of discretionary spending is financed outside the fiscal systems that parliaments use to control the executive. For example, Killick (2004) describes Ghana's budget process, dominated by donors working with an institutionally weak finance ministry, as a "façade".

This donor behavior is, of course, well-intended. Donors hope to create incentives for policy reform which they believe will be in the best interests of the country's citizens. Donors also have to be able to account for how their own taxpayers' money has been used, and to demonstrate to their stakeholders that it has yielded results. They want to minimize the risk that aid is used to fuel corruption in recipient countries. But in doing so, donors may be undermining the very systems of accountability and political control that are needed in the long run to ensure the evolution of states that would be responsive to the needs of their citizens.

However, while these are potentially serious criticisms of the aid relationship, they do not appear to give rise to diminishing marginal returns from aid. There is no reason why these accountability problems should grow disproportionately as aid increases.

6.2 Can the constraint be relaxed?

The introduction of the poverty reduction strategy (PRSP) process, and the reforms called for in the 2005 Paris Declaration on Aid Effectiveness (OECD, 2005), were intended in part to tackle these concerns. In principle, donors require recipient governments to submit their development strategies to greater scrutiny by local civil society organizations and domestic stakeholders, with the aim of increasing accountability. Moss *et al* (2006) underestimate the intention of this shift in their critique that *"PRSPs and conditionality, and other donor processes (even if better enforced) cannot fundamentally replace government accountability towards its citizens in an equally legitimate way, no matter how well-intentioned or vigilant the donors"*. The idea is not to use donor processes to replace government accountability, but to replace *policy conditionality,* in which donors hold governments to account for the policies they pursue, with *process conditionality*, in which aid is linked to the establishment of effective mechanisms for policy-making and domestic accountability. But progress towards reforming conditionality in this way has been at best patchy, partly because donors lack strong incentives to give up their role in policy-making.

Furthermore, progress has been constrained by impatience on the part of the donor community, which continues to sacrifice the long-term emergence and evolution of effective mechanisms of political accountability in favor of what they hope will be better results in the short-term as a result of their intervention.

There are positive signs of progress. Conyers and Mellors (2005) describe some examples in which external support has been provided to policies with a high degree of local ownership; but many others in which ownership has been lacking. Schneider (2005) describes the improvements that have taken place in Mozambique, and concludes that more aid and better donor behavior can support improved governance in aid recipients, but expresses concern that the behavior of a single donor bloc may overshadow accountability to parliament and civil society. Lister *et al* (2006) find that in seven countries that have received budget support, there is evidence of financial empowerment, strengthening incentives within government, and improved policy development across a range of sectors.

This part of the problem of political economy can be resolved if – and only if – the piper eschews the ability to call the tune. In those countries in which donors feel that the quality of governance and commitment to making progress on poverty reduction is sufficiently strong to warrant substantial increases in aid, donors should increasingly move towards reforms that reduce the corrosive effect of donor involvement on domestic accountability. In these countries, donors should:

- link aid to process conditionality rather than individual policies; eschewing the micromanagement of individual policies and programs;

- provide aid to support well-designed poverty reduction strategies, and resist the temptation to interfere in the process of compiling and implementing those strategies or to cherry-pick particular initiatives to support;

- provide support through the budget or medium term expenditure framework process, so that parliament can hold governments to account for their priorities, and finance ministries can exert effective discipline on line ministries;

- increase aid faster in countries that take genuine ownership of poverty reduction strategies and develop effective, costed plans to reduce poverty and promote economic growth, so lifting the budget constraint on the most effective governments;

- abandon additionality requirements which distort local prioritization;

- focus on long term outputs and impact as the basis for assessing the effectiveness of aid, and as a framework for accountability to taxpayers in donor countries, rather than the adoption of particular policies or particular donor priorities.

Though donors are already committed to moving in this direction in high-performing countries, change has been disappointingly slow, in part because donors must remain accountable to their own taxpayers for ensuring that aid has been properly used. A clearer message is needed that safeguards to ensure that aid is effectively should not be allowed to have the perverse effect of undermining the accountability of government in the countries that donors aim to support.

7. The resource curse

7.1 The problem

The second way in which aid can reduce accountability is known as the "resource curse". This literature suggests that governments that have "unearned" income – for example, revenues from oil, diamonds or other natural resources, lack sufficient incentives to build local institutions or to establish a clear social contract with the population (see Ross, 1999, Karl, 1997, Birdsall and Subramanian, 2004).

In some democracies, parties compete to spend public revenues effectively on public goods, balancing the benefits against the costs of taxation. But an alternative way to gain votes is to bribe opinion leaders through patronage. Where voters have strong local loyalties and limited information, patronage politics may be more cost-effective. In these conditions, strong checks and balances are needed to prevent embezzlement, corruption and patronage politics.

Scrutiny of government is a public good, and it is argued that scrutiny is more intense and effective if when the tax burden is higher. Mick Moore (1998) finds that countries which rely on a greater proportion of unearned income such as resource rents or aid will tend to be less democratic and have less effective institutions and accountability. Ross (2004) finds that "When citizens are faced with an undemocratic government that is charging unreasonably high prices for its services, they tend to demand democratic reforms."

Collier and Hoffler (2004, 2005) provide evidence that, over time, restraints on corruption and embezzlement are gradually eroded by the availability of resource rents such as oil or timber. They agree with Moore that the most likely mechanism for this erosion is that large resource rents radically reduce the need for taxation. Collier (2005) argues that large resource rents thereby subvert democracy by making patronage politics financially feasible.   Similarly, Heller and Gupta (2002) argue that aid creates a moral hazard because it reduces the incentive to adopt good policies and reform inefficient institutions.

So the concern is that aid may create a parallel problem to the “resource curse” by providing governments with an alternative source of revenues and so increasing the feasibility of patronage politics (Collier 2005, Moss et al 2006).

7.2 Can the constraint be relaxed?

The aid-as-resource-curse hypothesis depends on the proposition that governments in receipt of large quantities of aid raise less domestic revenue than they would if they did not receive aid, and so reduce the incentive for citizens to create effective checks and balances.

There is indeed a clear negative correlation between revenues from natural resources such as oil and tax effort. Collier (2005) finds that Africa’s oil exporters spend the same, but tax less, than the non-oil economies. But there is no similar strong inverse relationship between aid and tax. A simple comparison across countries of tax as share of GDP and aid as a share of GDP exhibits effectively no correlation. In a survey of the literature, Moss et al (2006) find some relationship between high levels of aid and low levels of taxation, but conclude that poor data quality makes it difficult to separate the effects of other factors such as low levels of economic activity, lack of industrialization and poor governance which are also correlated with both high levels of aid and low levels of tax. By contrast, a recent study of 11 African countries found that tax effort increased in the 1990s when aid flows increased (Bourguignon, Gelb and Versailles, 2005). With even the sign of the relationship unclear, it is fair to say that there is no strong inverse relationship between aid and taxation.[5] In the absence of a strong inverse relationship between aid and tax, it cannot be argued that aid generally reduces the incentive which taxation provides to develop effective checks and balances which limit patronage.

Furthermore, there is good evidence that aid does not have an impact analogous to oil. Collier (2005) reports that, when aid is introduced alongside resource rents in growth regressions, the hypothesis that they have the same effect can be decisively rejected. This suggests that the superior average results of aid are not simply due to better allocation among countries: within a given county aid and resource rents have distinctive effects. He finds that aid agencies are adding considerable value to the transfers that they administer which ensure that it is not used to fuel the kind of patronage that is seen in countries with large natural resource rents.

Collier concludes: “*The radical critics of aid are correct in arguing that large sovereign rents have been detrimental to development, but wrong in their casual conflation of resource rents and aid.*” Aid does not appear to have a significant negative effect on tax effort, nor does it fuel corrupt politics in the way that resource rents sometimes do. Nonetheless, it is reasonable to be concerned that governments that receive a lot of money from aid may be less accountable than if they raised all of their revenues through tax.

[5] See McGillivray & Morrissey (2001), Gupta, Pivovarsky & Tiongson (2003)

One straightforward mechanism to address this is to promote greater public transparency about how governments obtain and use their resources. Reinikka & Svensson (2003) describe how the accountability and effectiveness of education administration was increased in the Uganda by an information campaign that told parents what they were entitled to expect in their children's schools. This experiment in promoting increased accountability was found to be a success even though the vast majority of the education funds were originally provided by donors, because they flowed through the government budget and the voters were willing to hold the government to account for how they were used.

In addition, donors should adopt full transparency of aid, in which they "publish what they pay", analogous to the transparency initiatives that they are promoting for private sector firms engaged in extractive industries.

Increased funding of global and regional public goods

The seven constraints on increasing aid relate to the provision of aid to the poorest and most aid-dependant countries.

In addition to these, aid is used to finance the provision of global public goods. These include:

- research and development into new drugs, vaccines and diagnostic treatments, agricultural advances, appropriate sources of energy, etc;
- investments in the environment to slow climate change and in preserving biodiversity
- international peace and security, including more rapid willingness to use peace-keeping forces to prevent conflicts and build peaceful post-conflict societies;
- cushioning trade adjustment shocks and so allowing more rapid multilateral trade liberalization
- effective global and regional institutions for financial stability, prevention of corruption, control of money laundering, etc
- regional infrastructure (transport, communications, energy, water)

These public goods have been considerably under-funded despite the possibility of very large social rates of return (Kaul *et al*, 1999, Jamison 2000, Birdsall 2004a). One clear recommendation for donors who wish to increase aid and ensure that it is used effectively is to increase significantly the funding of these public goods.

Conclusions

The translation of Ovid at the front of this paper describes how Orpheus was allowed to lead his wife Euridice from the underworld only if he promised not to look behind him to check that she was following behind. But he could not bear to take this on trust, so he looked back to check that she was there. The result was that she was dragged back to the underworld. Paradoxically, donors may share

Orpheus's dilemma: the measures they take to try to reassure themselves of the effectiveness of aid may actually prevent the outcome they desire, by adding to transactions costs and undermining the evolution of domestic systems of accountability.

Table 1 below summarizes the discussion above of each of the seven possible constraints to effective aid absorption. In each case, it highlights the extent to which the constraint is a cause of reduced aid effectiveness, whether it is a possible cause of diminishing marginal returns, and the steps that could be taken to relax the constraint it might impose on the effective use of additional aid.

Table 1: Summary of seven constraints on aid absorption

	Reduces average aid effectiveness?	Causes diminishing marginal returns?	Main steps to relax the constraint
Microeconomic			
1. Transactions costs	Yes	Yes	• limit proliferation • more budget support • appraise spillovers • use recipient systems • link aid to results
2. Skills shortages	Yes	Yes	• minimize earmarking • improve technical assistance • long-term predictable aid
3. Limited number of worthwhile investments	No	Yes	• scale up successful projects • better evaluation • invest in strategic plan • untie aid
Macroeconomic			
4. Dutch disease from sustained aid flows	No	Yes	• investing in productivity • use aid for imports • make aid predictable
5. Macroeconomic volatility	Yes	No	• less volatile aid • more predictable aid • save temporary increases • use temporary spikes for imports • no additionality requirement
Political economy			
6. Donors erode accountability	Yes	No	• use process conditionality • support good PRSPs • no additionality requirement • give aid through budgets • give up micromanagement
7. Resource curse	Perhaps	No	• publish what you pay • information campaigns

A number of conclusions are apparent from this table:

a. The seven factors identified as possible constraints on aid absorption give rise to genuine reasons why aid might not be effectively used.

b. These constraints are mainly result of inefficiencies in the way that aid is given. In their efforts to ensure that aid is well-spent, donors may increase the likelihood that it is not.

c. The reforms to which donors have committed themselves in the Monterey Consensus (United Nations 2002) and in the Paris Declaration (OECD 2005 – see Annex A) would make a substantial contribution to relaxing possible constraints on the effectiveness of aid increases. While these reforms are not trivial, they are realistic and achievable, and considerably less demanding than the reforms that donors routinely expect developing countries to undertake.

d. Many of the measures needed to lift the constraints on the effective use of more aid can be more readily implemented in the context of high-performing and accountable recipient countries. This suggests that the bulk of additional aid should be directed towards these countries.

e. Investment in global and regional public goods has been under-funded. Additional aid for these purposes would have significant positive benefits for developing countries.

None of this should be taken to imply that an increase in aid is a sufficient condition for meeting the Millennium Development Goals. But an increase in aid may well be a necessary complement to the institutional and economic changes that will contribute to the reduction of poverty. This analysis is not about those imperatives. The goal is much more modest: to ask whether there are binding constraints that would prevent such an increase in aid from being effective. It finds that to the extent there are such constraints, it is within the power of donors to relax them.

To conclude: while there are constraints on the effectiveness with which additional aid can be used, they are not immutable laws of economics. Concerns about the ability of developing countries to absorb more aid should not lead donors to hesitate about increasing their aid budgets, but rather to redouble their efforts to implement the aid reform agenda to which they have already agreed.

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Annex A: Extract from the Monterrey Consensus

43. Recipient and donor countries, as well as international institutions, should strive to make ODA more effective. In particular, there is a need for the multilateral and bilateral financial and development institutions to intensify efforts to:

- Harmonize their operational procedures at the highest standard so as to reduce transaction costs and make ODA disbursement and delivery more flexible, taking into account national development needs and objectives under the ownership of the recipient country;
- Support and enhance recent efforts and initiatives, such as untying aid, including the implementation of the Organisation for Economic Cooperation and Development/Development Assistance Committee recommendation on untying aid to the least developed countries, as agreed by the Organisation for Economic Cooperation and Development in May 2001. Further efforts should be made to address burdensome restrictions;
- Enhance the absorptive capacity and financial management of the recipient countries to utilize aid in order to promote the use of the most suitable aid delivery instruments that are responsive to the needs of developing countries and to the need for resource predictability, including budget support mechanisms, where appropriate, and in a fully consultative manner;
- Use development frameworks that are owned and driven by developing countries and that embody poverty reduction strategies, including poverty reduction strategy papers, as vehicles for aid delivery, upon request;
- Enhance recipient countries' input into and ownership of the design, including procurement, of technical assistance programmes; and increase the effective use of local technical assistance resources;
- Promote the use of ODA to leverage additional financing for development, such as foreign investment, trade and domestic resources;
- Strengthen triangular cooperation, including countries with economies in transition, and South-South cooperation, as delivery tools for assistance;
- Improve ODA targeting to the poor, coordination of aid and measurement of results.

We invite donors to take steps to apply the above measures in support of all developing countries, including immediately in support of the comprehensive strategy that is embodied in the New Partnership for Africa's Development and similar efforts in other regions, as well as in support of least developed countries, small island developing States and landlocked developing countries. We acknowledge and appreciate the discussions taking place in other forums on proposals to increase the concessionality of development financing, including greater use of grants.