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Introduction

Poverty reduction must be the principal criterion against which official aid is evaluated. Sustained poverty reduction can be achieved in a number of ways. One such way is sustained economic growth. While growth is certainly not the most equitable, and possibly not the most efficient, means of poverty reduction, it is certainly a necessary one. To this extent, it is appropriate that the research has largely focused on the effectiveness of aid transfers in promoting growth. Another strand of the literature has focused on how aid is allocated among developing countries. Rarely if ever did these research areas intersect, in that studies seeking to explain observed or prescribe optimal inter-country aid allocations did not take into account effectiveness issues and vice versa.

Collier and Dollar (1999, 2002) changed this state of affairs with their ‘aid selectivity’ approach to inter-country aid allocation. Building on the empirical work of Burnside and Dollar (1997a, 1997b, 2000), which concluded that the effectiveness of aid in promoting growth depends on the policy regimes of recipient countries, Collier and Dollar derived ‘poverty efficient’ inter-recipient aid allocations. According to the prescriptive Collier–Dollar selectivity approach, optimal aid allocation favours countries with high levels of poverty, low per capita incomes and sound policy regimes. Such allocations are considered poverty efficient by maximising the number of people pulled out of poverty. Countries with unsound policy regimes receive less aid in the Collier–Dollar selectivity approach as these regimes lessen aid’s impact on growth and thus poverty reduction.

This Burnside–Dollar and Collier–Dollar research has spawned a number of subsequent academic studies. All agree with the fundamental thrust of this research: that aid is effective in promoting growth and, by implication, in poverty reduction. This has proved to be a particularly robust conclusion, drawn by practically all subsequent empirical studies of aid and growth (Collier and Dollar 1999, 2002; Svensson 1999; Collier and Dehn 2001; Collier and Hoeффler 2002; Hansen and Tarp 2000, 2001; Lensink and Morrissey 2000; Lensink and White 2000, 2001; Dalggaard and Hansen 2001; Guillaumont and Chauvet 2001; Hudson and Mosley 2001; Lu and Ram 2001; Chauvet and Guillaumont 2002; Dalggaard et al. 2002; Ram 2004). There is also evidence that foreign aid has promoted growth in the Pacific (Gounder 2001, 2002).

Ambiguity over the aid–growth linkage, which persisted for many decades, has in general been removed and the well-known macro/micro paradox of official aid is dead and buried. These studies are yet to provide such clarity over the relevance of recipient country policies for effectiveness, with many failing to produce similar empirical results to those reported in the Burnside–Dollar studies. To this extent the Burnside–Dollar results remain a topic of significant controversy. But it should be remembered that this debate is largely over whether it is possible, in the context of the econometric analysis of cross-country (panel) data sets, to observe a link between aid effectiveness and policy. It is not so much about the relevance of policies per se, there is rather a general acceptance among researchers that better policies, however defined, should in all probability result in more effective aid (Robinson and Tarp 2000; Benyon 2001, 2002; Morrissey 2002; Collier 2002).

There are, however, many other areas of aid research in which there is far more clarity. These areas have been the subject of extensive research conducted over many decades and include studies on public sector aspects of aid (including fungibility), ex post and ex ante conditionality (including structural adjustment), aid and the real exchange rate, the determinants of inter-country aid allocation and NGO effectiveness. In some instances these agreements have been reached following the availability of better data sets and application of more rigorous research methods. There are also a number of new areas of research that have emerged. These include aid and conflict prevention, aid and growth in post-conflict scenarios, aid and governance, and allocating aid via non-traditional channels.

This paper surveys research on aid effectiveness. It updates and extends the coverage of Benyon (2001, 2002) and McGillivray (2003, 2004) by looking inter alia at more recent research on the contribution of aid to growth. The overall focus is on the relevance of these issues for poverty-efficient aid, defined as a pattern of inter-recipient aid allocation that maximises poverty reduction. It identifies a range of poverty-reducing criteria, in addition to policy, on which aid allocation or selectivity might be based.

The paper is built on the recognition of two key points. The first is that effectiveness of aid in promoting growth is in theory contingent on a range of factors in addition to policy, such as conflict reduction, vulnerability mitigation, political...
stability and governance. The second recognition is that, more importantly, the ultimate objective of aid is poverty reduction or, more broadly, the promotion of human wellbeing. This is made very clear in the adoption of the Millennium Development Goals (MDGs), which identify poverty reduction as the ultimate objective of development efforts. Fuelling growth is one of a number means by which this objective can be achieved.

This paper looks first at the general linkage between aid, growth and poverty reduction. It examines new directions in research on aid and growth, highlighting work on the relevance of shocks, structural vulnerability, post-conflict scenarios, democracy, political instability and absorptive capacity. Secondly, it attempts to establish a broader concept of selectivity, by distilling various strands of argument presented in the preceding section, and in doing so looks at a variety of channels through which aid might reduce poverty, and on which poverty-efficient allocations might therefore be based. It is recognised, in particular, that aid can and should aim to reduce poverty other than by means that rely purely on growth per se.

Aid–growth–poverty reduction linkages

While the research effort on aid, growth and policy is ongoing, a number of new directions on aid effectiveness have emerged. The focus remains on aid and growth, but a number of factors in addition to policy are taken into account. Trade shocks and aid effectiveness have been analysed in Collier and Dehn (2001). Developing countries can be highly shock prone, and trade shocks can have substantial adverse consequences for growth.\(^3\) Shocks are defined in terms of changes in export prices. The hypothesis is that aid can potentially cushion the adverse growth effects of negative export price shocks through providing a buffer.\(^3\) This effect is manifested by the level of political instability. Results also indicated that aid effectiveness is negatively influenced by the level of political instability. Results also indicated that aid is more effective in structurally vulnerable countries, confirming the result of Guillaumont and Chauvet (2001).

The impact of aid on growth in post-conflict scenarios is examined in Collier and Hoeffler (2002). They note that the economic circumstances of post-conflict countries can be distinctive in many respects: the need to restore infrastructure combined with a collapse of domestic revenue can make aid unusually productive and growth can be supranormal (Collier 1999).\(^3\) Offsetting this, though, is what Collier and Hoeffler describe as a ‘persistent high-corruption equilibrium’ since the incentive for a reputation of honesty is often disrupted during civil war (Tirole 1992). Collier and Hoeffler empirically tested whether aid is more effective in post-conflict scenarios by a series of augmentations to the Burnside and Dollar aid–growth model. Based on a range of estimates, the results showed that aid is more than twice as productive in post-conflict episodes for given policies; that there is a temporary growth spurt of approximately two percentage points higher than otherwise during these episodes; and that in the absence of aid there would be no growth spurt.

The effect of democracy on the aid–growth nexus is examined in Svensson (1999). Democratic institutions (such as political parties, elected representatives, free speech and the right to organise) should provide a recurrent and institutionalised check on government power, encouraging governments to use aid productively and preventing them from using it unproductively. Thus, it is hypothesised that aid will have a greater impact on growth the greater the degree of democracy. The degree of democracy is measured using indicators of political
and civil rights from Freedom House and formed into an index. In this aid–growth model, democracy impacts directly on growth and also via its interaction with aid. Results obtained from estimating this model indicated that while democracy had no significant direct impact on growth, the coefficient attached to the interaction between aid and democracy was almost without exception significant and positive. Svensson concluded, therefore, that the growth impact of aid was conditional upon the degree of democracy. Kosack (2003) also drew this conclusion, but in the context of the impact of aid on the quality of life, the latter measured by the Human Development Index.

Aid ‘transmission mechanisms’, or channels through which aid can potentially contribute to growth, are the focus of Gomance et al. (2002a). Aid can effect growth directly, but also through its impact on investment, imports, public-sector fiscal aggregates, and government policy. Conscious recognition of these mechanisms has important implications for modelling the aid–growth relationship in order to avoid double counting the impacts of aid. Gomance et al. tested for the presence of the aid–investment–growth mechanism, finding strong evidence that it existed. Morrissey (2002) suggested, on the basis of this result, that government policies can play an important role in enhancing aid effectiveness through seeking to improve the productivity of investment. This also applies to the other mechanisms. For example, policies aimed at improving the productivity of government expenditure should improve aid’s impact on growth provided the aid–fiscal aggregates mechanism exists. This research is linked with the extensive and longstanding literature on aid and public-sector fiscal behaviour, which generally finds that aid is associated with increases in government expenditure categories, including pro-poor expenditures, the fungibility problem notwithstanding. Gomance et al. (2002b) look at aid and pro-poor expenditure directly, using the abovementioned transmissions mechanisms approach, finding that aid is associated with increases in these expenditures and, in turn, improvements in welfare.

Diminishing returns to aid effectiveness have been examined closely by most recent aid–growth studies, through the inclusion of an aid-squared term in their models. This tests for non-linearity in the aid–growth relationship, with aid being positively related to growth up to a certain level of aid and negatively related thereafter. The coefficient on the aid-squared term is consistently negative and significant, indicating that there are diminishing returns to aid effectiveness. This is a seemingly highly robust finding, with almost all studies reporting such a relationship, with negative returns setting in when the aid inflow reaches anywhere between 15 and 45 per cent of GDP. This has been interpreted as indicating limited aid absorptive capacities, with recipient governments being limited in the amounts of aid they can use effectively (Clemens and Radelet 2003).

Aid selectivity: Towards a broader concept?

A number of key points emerge from the preceding discussion. Regarding effectiveness, aid fundamentally works, but it is clear that its impact differs across countries depending on the conditions they face. It is agreed that policies do matter, or at least potentially matter, for the effectiveness of aid, although there is ambiguity over whether this has been correctly observed from empirical estimates of aid–growth models. Aid seems to work better in post-conflict situations, in structurally vulnerable countries (including those undergoing trade shocks), in politically stable regimes and in countries with good governance records, although there would appear to be diminishing returns to its impact on growth.

What does this mean for poverty-efficient allocations? It must be recognised that aid can reduce poverty through its impact on growth, but that its effectiveness in promoting growth varies according to a range of factors. It must also be recognised that aid can reduce poverty through other channels. A channel, for which there is empirical support based on the literature identified above, is aid’s impact on pro-poor public expenditure (there will of course be others).

Thus, there appears to be a reasonable case for augmenting and extending the Collier–Dollar selectivity model, just as the Burnside–Dollar growth model has been augmented in analysing aid and growth. Donors are well positioned to do this, and to some extent have begun to do so through their own allocation initiatives. The essence of the augmentation would appear to be relatively straightforward and emanates directly from the findings of the aid–growth studies discussed above.

Aid should not only be allocated to countries with low per capita incomes and large numbers of people living in poverty and with good policies, but also to poor countries in post-conflict scenarios, to those which are structurally vulnerable, to those which have democratic and politically stable regimes, and those with broader good governance records. Based on the evidence discussed above, this should lead to a greater impact on growth and in turn on poverty reduction. Indicators used in the studies discussed above provide the information on which such an allocation can be based. Attaching weightings to these indicators, as is required in a selectivity formula, should in principle be based on scientific empirical research, however, donors will in practice assign weightings based on field experience, anecdotal evidence, intuition and political considerations.

The extension to the Collier–Dollar selectivity approach is more fundamental. Based on the recognition that there are many other determinants of poverty, it would at minimum involve giving additional preference to those recipients who can translate aid into increased pro-poor public expenditure or, more simply,
those governments with high levels of pro-poor expenditure on the assumption that the aid-pro-poor public expenditure elasticity is the same across all countries (Collier and Dollar adopt a similar assumption regarding an income-poverty reduction elasticity). A way of formally incorporating the relevant variables and parameters into the Collier–Dollar the selectivity model would need to be found. In the absence of this, donors could simply add some indicator of pro-poor expenditure to a more general selectivity formula.

There is, however, the issue of diminishing returns to aid, presumably resulting from limited aid absorptive capacities. This is a potentially serious issue if selectivity results in significantly increased aid to individual countries. A potential solution to this problem is also a suggested solution to a possible consequence of basing aid allocation on policy regimes, that being the denial of aid per se to countries with bad policies, and possibly with high poverty incidence. Suggested by Collier (2002), it involves bypassing recipient country governments and allocating aid via in-country ‘independent service authorities’ (ISAs), which could include NGOs. This could be done not only with countries with policies so bad that aid will be ineffective in any developmental sense, but with other countries at levels of aid where diminishing returns are thought to set in. Not only could this see aid being allocated to, and poverty being reduced in, countries with bad policies, but it could also relax possible absorptive capacity constraints. More generally, it would seem reasonable to assume that a broadening of the selectivity concept, and allocating aid in non-traditional manners, such as through ISAs, would see more aid go to the very poorest countries. This would garner broader support for a policy of selectivity among donors and the international development community in general.

Notes

* This paper is based on McGillivray (2003), which was originally presented at the Joint OECD DAC/Development Centre Aid Experts’ Seminar at the OECD Headquarters, 10 March 2003. Correspondence should be addressed to Professor Mark McGillivray, World Institute for Development Economics Research, United Nations University, Katajanokanlaituri 6 B, 00160 Helsinki, Finland; email: mark@wider.unu.edu

1. Easterly et al. (2003), and Hughes (2003) provide dissenting views on aid effectiveness. The first of these studies provide a valid reminder that panel data econometrics can provide rather fragile results, which should be treated with a healthy scepticism. However, given the consensus of the large body of recent aid effectiveness research, these views represent those of a minority.

2. Note that it is incorrect to conclude that, on the basis of the Burnside and Dollar studies, aid only works in countries with a good policy environment. The correct interpretation is that foreign aid is more effective in countries with better policy environments. Aid is still effective at spurring growth in countries with poorer policies, but by not as much as in countries with better policy environments. Moreover, the studies do not examine whether aid has an impact on the level of policy.


4. An alternative interpretation is that the impact of democracy on growth is contingent on the level of aid. This points to a more general interpretation problem regarding the aid interaction terms used in the aid–growth literature in general.


6. Among the studies reporting diminishing returns are Collier and Dollar (2002), Collier and Hoefller (2002), Hansen and Tarp (2000, 2001), Dalgaard and Hansen (2001), Hudson and Mosley (2001), Lensink and White (2001) and Dalgaard et al. (2002). Heller and Gupta (2002) provide a useful discussion of this issue, along with the related problem of Dutch Disease. Note though that Gomance et al. (2003), using a general technique specifically designed to detect threshold effects, struggle to find evidence of such returns and therefore question the inferences drawn by previous studies.


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