AID AND ECONOMIC GROWTH IN DEVELOPING COUNTRIES: A LITERATURE REVIEW

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Abstract. The literature on aid’s impact on economic growth and poverty has been marked by a wide diversity of approaches often emphasizing widely divergent and contradictory conclusions. The earlier literature highlighted the critical importance of foreign assistance in economic development in terms of the two-gap theory which stated that aid promoted economic development by relaxing savings and foreign-exchange constraints to capital formation and economic growth. However, subsequent research in later years shifted to other lines of thoughts whereby it was found that aid either displaced or had no impact on domestic savings. In subsequent years, the trend in aid effectiveness studies was to emphasize conditionality, better selectivity and the policy environment in the recipient countries. Then, since the recent calls for increasing aid flows to achieve the Millennium Development Goals, studies on aid effectiveness started focusing on the need for increased aid harmonization and alignment. In order to understand better these various theoretical underpinnings of the macroeconomic impact of aid, this paper will provide an analysis of the literature review on aid effectiveness, with a focus on the meaning of Official Development Assistance, the institutional and policy framework and aid harmonization.

Introduction

Aid effectiveness has attracted considerable attention in the economic development literature, both in terms of publications and policy debates. The emerging consensus would seem to be that aid does have a positive impact on growth but its effectiveness should be improved. Increased emphasis is being placed on poverty reduction in policy debates, and the international community has come to expect much of foreign development

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aid in recent years, especially since the adoption of the Millennium Development Goals (MDGs) at the United Nations Millennium Summit in September 2000. A way of understanding the relationship between aid, economic growth and poverty is to look at the research literature on aid effectiveness and allocation. To this end, this paper presents a literature review on the macroeconomic impact of aid, with a focus on Official Development Assistance (ODA), and the related institutional and policy framework, including the need for aid harmonization.

**Aid and Economic Growth**

*Early Theories on Aid and Economic Growth*

In the post-war literature, aid was central to development discussions within the ‘capital bottleneck theories’ (Meier and Stiglitz, 2001; Chenery and Strout, 1966). Capital scarcity was considered as a major contributory factor to economic backwardness. External finance was seen as a way out of poverty and stagnation by providing developing countries with much needed and scarce investment goods.

Strongly influenced by the experience of European reconstruction following the Second World War, early growth models stressed the role of capital and capital formation in development (Papanek, 1972). Growth was seen to require real resources for the production of capital goods, that is, goods such as industrial plant, machinery, and social overheads that were not for immediate consumption, but could increase the production potential in future periods. However, as underdeveloped countries were seen to be capital deficient, it followed, almost axiomatically, that unlocking development required in turn the overcoming of this main constraint to growth.

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1 Aid flows can be categorised in terms of origin of funds, that is, by the private and official flows. Private sources consist primarily of direct investment, export credits and increasingly since the early 1970s, commercial debt. Official sources comprise bilateral transfers that arise from governments, and multilateral transfers that arise from international agencies. What is commonly known as ‘aid’ is that part of these official transfers that normally includes an element of ‘concession’. This is what is commonly known as (ODA). This type of assistance consists of grants (including technical assistance), concessionary loans, contributions in kind, suppliers’ credit, and reparations payments. This indicates that not all types of ODA take the form of ‘give away’ grants or charitable donations.
This idea dates back to economist John Maynard Keynes who in the 1930s argued that governments could stimulate development by financing investments (Meier and Stiglitz, 2001). Keynes’ ideas for the domestic economy were taken up by a new breed of development economists who argued that investment in developing countries could be stimulated by injections of cash from overseas. The logic of this new development theory was simple: investments are determined by savings and savings are determined by per capita income. Since poor countries have low incomes and accordingly, low savings, they are caught in a vicious circle of poverty, that is, they experience a low-level equilibrium trap whereby higher income does not lead to increased savings but only results in higher population growth. Thus, it was argued that investment financed by foreign aid would dissolve the vicious circle and connect developing countries to the virtuous circle of productivity and growth. Following this theory, it was assumed that donors can simply calculate the financing gap, which is the difference between domestic saving and the level of investment required for a targeted rate of economic growth, and thereby fill it with aid (Meier and Stiglitz, 2001).

The Harrod-Domar (Harrod, 1948; Domar, 1947) growth model was the most well-known formulation of the gap theory. The model assumes that there is an excess supply of labour and that growth is constrained only by the availability and productivity of capital. Since savings in developing countries are likely to be too low to achieve a target growth rate, foreign aid was needed in order to relieve the savings constraint and increase investment thus leading to economic growth.

In addition to a savings gap, Chenery and Strout (1966) identified a foreign exchange gap, noting that developing countries are unlikely to have the export earnings required to import capital goods for investment. Again, the authors identified that foreign aid could help fill this gap and hence developed a ‘dual gap’ model.

A third gap was identified by Bacha (1990) and Taylor (1990). They recognised that some governments of developing countries simply do not have the revenue raising capacity to cover a desired level of investment. Thus, it was concluded that foreign aid provided directly to the government could potentially relax this fiscal gap as long as it was used for investment purposes. In sum, gap models assert that foreign aid can supplement
savings, foreign exchange and domestic revenues. This allows for a greater level of savings and investment which lead to economic growth. However, despite the existence of three gaps which aid can potentially fill, the majority of aid effectiveness studies focussed on the first of these gaps and therefore the relationship between foreign aid and savings.

**Aid Effectiveness**

Early research on aid, dating back to the 1950s, was consistent with the optimism of aid effectiveness. It actually provided a conceptual foundation for this optimism. Aid was analysed in the context of the two-gap model of aid, which itself was very much of the Harrod-Domar growth tradition. However, as White (1992) and others pointed out, these levels of aid were more than achieved, and yet the anticipated growth was not. Subsequent empirical research tried to analyse the reasons for this by looking at the relationship between aid and domestic savings and found that the connection between aid and savings was not as clear cut as had been assumed earlier.

Many empirical studies, such as that by Mosley *et al.* (1987) concluded that aid did not lead to increased growth and may have even worsened recipients’ economic performance. Recent studies continue to paint a mixed picture. In fact, an overview on the lines of thinking on the impact of aid indicates that there are two strands of reasoning: the one which indicates that aid has an impact and the one that indicates that aid does not (Papanek, 1972; Papanek, 1973; Mosley 1987, Mosley *et al.*, 1987).

Empirical studies conducted in the late 1960s and early 1970s, set off a huge controversy. Mosley *et al.* (1987) summed up the situation by coining the term, ‘macro-micro paradox’ of aid given that while most micro or project-related studies were quite clear about a positive impact of aid, macro-level studies could provide no such clarity. In several studies, the positive relationship between foreign capital flows and savings predicted by the Harrod-Domar model was not observed. In fact, these studies generally found a negative relationship between the two variables. An explanation for these findings is provided by Griffin and Enos (1970). They contested the assertion of gap models that foreign aid leads to a one-to-one increase in savings, arguing that unless an aid recipients’ marginal propensity to save is equal to 1, a part of foreign aid will be allocated to consumption rather than
savings. In his empirical analysis using cross-country data, Griffin (1970) supported this argument, reporting a negative association between capital inflows and domestic savings. The finding was supported by Rahman (1968) while Gupta (1970) found no relationship between foreign capital inflows and domestic savings in his study.

Papanek (1972) provides an alternative explanation for the finding of a negative association between foreign capital flows and savings. Papanek noted that domestic savings are used as the dependent variable, calculated as national income minus consumption. This implies that if any part of foreign aid is used for consumption, the impact on domestic savings will be negative, *ceteris paribus*. Given that donors are not adverse to funding some components of consumption, the issue of importance is whether total savings (domestic savings plus foreign aid) fall. Therefore, Papanek (1972) found that unless the coefficient on the aid variable is significantly less than –1, it can be concluded that although foreign aid displaces savings, total savings increase.

Papanek (1973) provided the first study to disaggregate foreign capital flows into foreign aid, foreign investment and other flows. Although the study investigated the impact of foreign on domestic savings, it was also influential in enhancing the debate on aid effectiveness. Papanek (1973) found strong evidence that foreign aid flows are positively associated with higher growth rates in recipient countries. A number of aid effectiveness studies followed Papanek (1973) by often augmenting his model with other explanatory variables. However, no overall consensus emerged regarding aid effectiveness.

*Ambiguous Results*

Mosley (1980) made an important contribution to the literature by incorporating lagged aid variables into his model and by accounting for the potential endogeneity of aid. On average, Mosley found a negative association between aid and growth although the coefficient on the aid variable was not statistically significant. A positive and statistically significant impact of foreign aid was found when the sample was restricted to the poorest 30 countries in the sample and aid was lagged 5 years.

Later Mosley *et al.* (1987) provided one of the most-cited studies of aid effectiveness during the 1980s. They used different estimation techniques to
investigate the impact of aid on growth for 63 countries over the period 1970-1980. The authors found no statistically significant relationship between aid and growth using various sub-periods and samples of developing countries.

Boone (1996) provided the stimulus for the aid effectiveness debate in mid 1990s. Using panel data for 91 countries covering the period 1971-1990, Boone investigated the impact of foreign aid on investment, consumption and measures of well-being. He also examined whether aid effectiveness was conditional on the political regime. Results indicated that foreign aid leads to increases in government consumption rather than increasing investment or benefiting the poor.

In sum, up to the late 1990s there was no consensus regarding the impact of foreign aid on economic growth. Results from empirical studies were ambiguous with no conclusive evidence that foreign aid was effective at promoting economic growth in recipient countries. On this matter, Cassen and Associates (1994) commented that:

‘Research on the macroeconomic effects of aid deals with relatively large groups of developing countries. Its results are ambiguous. The relationship between aid and growth is rather weak: it can be either positive or negative, depending on the country groupings and the time period chosen. The relationship between aid and savings was once thought to be stronger and negative. But the reasons why it was found to be so remain unexplained…’ Cassen and Associates (1994: 15–16)

Additionally, Mosley (1987) pointed out that

‘…there appears to be no statistically significant correlation in any post war period, either positive or negative, between inflows of development aid and the growth rate of GNP in developing countries when other casual influences on growth are taken into account’. (Mosley, 1987: 139)

On a similar note, White (1992:121) argued that

‘we know surprisingly little about aid’s macroeconomic impact’, but adds that ‘the combination of weak theory with poor econometric methodology makes it difficult to conclude anything about the relationship between aid and savings…and aid and growth’.
A New-found Optimism

Research on aid effectiveness in the late 1990s has been very important in shaping donor policy. A prime example is research carried out by the World Bank (1998). This research was used to develop an argument in favour of the fact that aid works, but only when policies are right. This was a policy ‘narrative’ that donors seized on and that arguably played a large part in stimulating the recent increase in aid, the volume of which had stagnated for much of the 1990s.

Burnside and Dollar (2000) concluded that aid had a positive impact on growth for developing countries with good fiscal, monetary and trade policies in place, but had little impact for those countries with poor policies. This therefore, partially at least, provided an explanation of why aid had been found to have little positive impact on growth in previous empirical work. It also provided specific criteria for targeting aid. Building upon this work, Addison et al. (2005) argue that one can be more certain that aid will reduce poverty through growth when aid itself is used to invest in the livelihoods of the poor thereby raising the poverty-elasticity of growth. Aid that finances pro-poor public spending on services and infrastructure improves the productivity of the poor as well as their human development indicators more broadly.

Therefore, the reason to why does aid now appears to work at the macro level, after decades of little or no clarity over its effectiveness, is a matter of debate. A widespread view as to why this is so is that donors, following the demise of the Cold War, are paying more attention to development criteria in the design and application of aid activities (Burnside and Dollar, 2000; McGillivray, 2003; Collier and Dollar, 2004). However, another plausible reason as to why aid is now thought to have a positive impact is that recent studies employ better empirical methods and have access to better data thus making it possible to observe such an impact. Thus, this implies that aid might have always been effective, and that earlier studies were simply not able to observe such an impact.

On the other hand, Guillaumont and Guillaumont (2007) argue that two opposing views seem to dominate the present aid debate: the ‘big push’ theses and the ‘absorptive capacity’ concern. The big push is supported in particular by Sachs (2005) and is based on the poverty trap concept, while the
absorptive capacity concern collects in a multi-fold concept several opposing views to the first approach. On one hand there is the United Nations commitment of doubling aid to reduce poverty by half, and on the other hand there is the reviving scepticism that aid will not be absorbed usefully. Accordingly, Guillaumont and Guillaumont (2007) argue that aid is back on the international agenda, and that after more than a decade of aid fatigue, the international community envisages substantial increases in aid flows to poor countries in Africa and parts of Latin America and Asia.

In fact, in the campaign for increased aid and in the work by Sachs (2005) for the United Nations Millennium Project, the gap theory has been energised and is back in full bloom. In his work, Sachs (2005) utilised the conventional form of a financing gap calculation, whereby Sachs concluded that to meet the MDGs, low-income countries need US$450-50 per capita in external funding in 2006 and US$70-100 per capita in 2015. In a separate paper published by the Brookings Institution, Sachs and his colleagues (2004) argued that what is needed is

‘a big push’ in public investments to produce a rapid step increase in Africa’s underlying productivity, both rural and urban...In particular, we argue that well-governed African countries should be offered a substantial increase in official development assistance to enable them to achieve the MDGs, the internationally agreed targets for poverty reduction by 2015.’

Judging by recent political developments, Sachs’ vision may become reality. However, according to Guillaumont and Guillaumont (2007), while a generous scaling-up of foreign aid seems an indispensable condition for reducing poverty and achieving global prosperity, history has shown that it is not sufficient. In their paper, the explanation to why foreign aid has failed to attain development objectives is approached from two perspectives. On the one hand, they argue that foreign aid is partially wasted by recipient governments and inherently poses incentive problems and produces negative externalities, which in turn diminishes its effectiveness. On the other hand, the allocation of aid by donor countries has been questioned. The authors argue that if donors allocate aid according to some strategic considerations and do not respond to the need of beneficiaries, then why should one expect improved growth or poverty reduction in recipient countries?

Furthermore, Guillaumont (2008) argues that aid effectiveness depends inter alia on some specific features of recipient countries, whereby if such
features are well identified then they should be retained as aid allocation criteria, such that aid will be allocated effectively. Guillaumont argues that a preliminary issue is the determination of aid goals, which it can be agreed that these are the MDGs. However, the bulk of the analysis of aid effectiveness is related to the relationship between aid and economic growth. Indeed, the poverty reduction MDG goal and some other MDG goals as well, depend primarily on economic growth, but according to links and coefficients that are likely to differ among countries. Thus, factors of aid effectiveness should normally refer to a broader scope than only growth.

Accordingly, Guillaumont (2008) indicates two main kinds of factors of aid effectiveness that have emerged from the last decade debate: primarily there are the factors related to policy, institutions and governance and secondly there are the factors related to exogenous shocks and structural economic vulnerability. Policy, institutions and governance are important factors, whereby the basic idea is that aid is more effective when the policy and institutional environment are ‘good’ because aid is then more likely to be used rationally or not wasted. The determination of aid effectiveness by the quality of policy and institutions is also a basic relationship in the model of optimal aid allocation by Collier and Dollar (2001, 2002). However, the robustness of the econometric findings has been seriously debated (e.g. Hansen and Tarp, 2001; Dalgaard and Hansen, 2001; Lensink and White, 2001; Easterly, 2003, Roodman, 2007) whereby it is argued that this relationship relies on the hypotheses that aid has no effect on policy.

The second category of factors identified by Guillaumont (2008) is related to exogenous shocks and structural economic vulnerability, to which can be added the post-conflict situation. Guillaumont highlights that while vulnerability to exogenous shocks, external or natural, is a negative factor of growth, aid is likely to dampen their effects, lowering the relative shortfall of resources and avoiding economic collapse. Furthermore, as argued by Collier and Hoeffler (2004) in post conflict situations, aid facilitates recovery and lowers the risk of new conflict.

Aid and Policy Frameworks

A report by the World Bank (1998) provided a new stimulus to the discussion on the macroeconomic effectiveness of development aid and was one of the
first studies acknowledging that aid effectiveness may depend on specific circumstances in recipient countries. The analysis fits well into a new wave of aid effectiveness studies that emerged since the late 1990s. As argued by Hansen and Tarp (2000), these studies of aid effectiveness are considerably different from the traditional aid effectiveness studies.

According to the World Bank (1998) aid does help to increase growth, but only in countries with sound economic management or ‘good governance’. The main conclusion of the report was that aid allocation should be based on selected recipient countries according to their policy environment. The claims of the World Bank report with respect to the effectiveness of aid were mainly based on a number of background studies, and especially the ones by Burnside and Dollar (2000) and Collier and Dollar (2001, 2002). In a cross-country regression analysis for 40 low-income countries and 16 middle-income countries over 1970-1993, Burnside and Dollar (2000) estimated a neoclassical growth model, in which aid was included and aid was interacted with a policy index variable, together with a number of variables that are usually included in growth models. The policy index was a weighted index of the budget surplus to GDP ratio, the inflation rate and an index reflecting trade openness as constructed by Sachs and Warner (1995). These variables were proxies for fiscal, monetary and trade policy, respectively. Burnside and Dollar concluded that aid has a positive impact on real GDP per capita growth, but only when aid is interacted with a policy index variable. In other words, aid may increase growth, but only when the government of a country carries out ‘good’ fiscal, monetary and trade policies.

On the same line of thinking, Collier and Dollar (2002) tried to determine a ‘poverty-efficient allocation of aid’. The model specification of Collier and Dollar included both the quadratic aid term as well as the interactive aid-policy term. According to them, reallocating aid flows to poor countries with a good economic policy environment would reduce the number of poor people by an extra 18 million per year as compared to the number of people that are helped out of poverty based on the existing allocation of aid flows. Thus, targeting of aid in this manner would almost double its effectiveness in reducing poverty.

The World Bank report (1998) provoked a huge reaction in the research community. Several researchers have tried to redo the econometric analysis of the Burnside-Dollar aid-growth model. Dalgaard and Hansen (2001),
Hansen and Tarp (2001), Lensink and White (2001), Jensen and Paldam (2003), Islam (2002) and Ram (2004), among others, have analysed the aid-growth relationship, using an interaction term between aid and a policy measure as suggested by Burnside-Dollar. Although these studies sometimes used different data sets, different model specifications and different econometric techniques, it is nevertheless surprising that none of these studies found the interactive term of equation to be statistically significant. Dalgaard and Hansen (2001), for instance, showed that the result that aid is only growth enhancing in a good economic policy environment, crucially depends on the fact that Burnside and Dollar in their paper deleted five observations form the data set.

However, the strongest attacks on the robustness of the Burnside-Dollar aid-growth model, was presented in papers by Easterly et al. (2004) and Roodman (2004). Easterly et al. (2004) used the same data set, model specification and econometric technique as Burnside and Dollar did and extended the data set using four more years of data. Based on this analysis, they concluded that the interactive term was no longer statistically significant. Similarly, Roodman (2004) in his paper presented not only the Burnside and Dollar results, but also those of Collier and Dollar (2001, 2002) and Collier and Hoeffler (2002) and found little empirical support for the aid-policy link.

Thus, based on the work of those researchers who tried to redo the work by Burnside and Dollar, the conclusion is that the claims made on the importance of the policy environment for the effectiveness of aid are rather fragile.

**Alternative Views Regarding Effectiveness of Aid**

A number of alternative views on the effectiveness of aid have been suggested. These can be grouped under four headings:

- Aid has decreasing returns,
- Aid effectiveness is influenced by external and climatic conditions,
- Aid effectiveness is influenced by political conditions, and
- Aid effectiveness depends on institutional quality.

**Decreasing returns to aid.** Several authors suggest that giving aid may have decreasing returns. The decreasing returns of aid can be explained through the limited absorptive capacity of countries to take up large inflows of foreign capital and the problem of the Dutch disease effects. Two particular
studies do not find support for the decreasing returns of aid hypothesis. One study by Jensen and Paldam (2003) investigates the claim that giving aid has decreasing returns by simplifying the econometric model so that more observations can be taken into account than in the original data set used by most other empirical studies. This study carried out an out-of-sample replication of the aid-growth estimations with the extended dataset, whereby also for the extended dataset they found decreasing returns of aid.

**Aid uncertainty.** A few studies have investigated the patterns of aid flows and have found these flows to be rather volatile. Lensink and Morrissey (2000) investigate the impact of volatile aid flows on the effectiveness of aid. In their analysis, the volatility of aid is seen as a measure of the uncertainty of aid flows of a recipient country. The uncertainty of aid flows is measured as the deviation of actual aid flows from expected aid flows, where expected flows are based on a simple autoregressive process (with or without a time trend). The reasons for aid flows being uncertain may be either explicit donor country policies or actions or external shocks. In either case, aid uncertainty may have an adverse impact on government expenditures, and in particular on public investment. A reduction of public investment may in turn lead to lower private investment, and ultimately also to lower economic growth. In their study, Lensink and Morrissey add their measure of aid uncertainty to a growth equation, which incorporates standard exogenous growth variables, including a measure of aid flows. They use data for a sample of 75 developing countries, using average values of variables for the period 1970–1995. The estimation results show that while the aid uncertainty variable has a negative impact on growth, aid has a positive effect.

This confirms the hypothesis that aid in itself contributes to higher growth, but that the effectiveness of aid is reduced when aid flows are more volatile. The authors therefore suggest that donors and recipients should develop more stable relationships to increase aid effectiveness.

Bulir and Hamann (2003) found that aid flows are highly volatile, and their volatility is even higher than the government’s domestic budget revenue. They found that the volatility of aid flows is higher the more aid-dependent countries are. Subsequently, they find that aid falls during periods in which domestic revenues of governments also fall and that the volatility of domestic revenues coincides with the volatility of aid flows. Thus, these findings would seem to suggest that although aid flows may increase the overall
resources governments have, aid is currently disbursed ‘…in a less than ideal manner’ (Bulir and Hamann, 2003:83).

_Aid and Political Instability._ Some authors have investigated whether political instability in the recipient country matters for the effectiveness of aid. Political instability refers to irregular changes in the political system. The sources of instability may be twofold. On the one hand, political systems may change due to political violence, such as riots, strikes, and assassinations. Frequent political instability, in turn, may lead to unpredictable changes in laws, regulations, government policies, taxation and expenditures and property rights. The uncertainty created by these changes may reduce incentives for investment and consumption, leading to lower economic growth.

In a similar vein, it may negatively affect the impact of aid on growth. Islam (2002) studied this issue, using annual data for a sample of 21 Sub-Saharan African and 11 Asian countries for the period 1968-1997. By adding a political instability measure and its interaction with aid to a Burnside-Dollar-type of growth model, Islam concluded that the interactive term of aid and political stability was positive and statistically significant. In contrast, the interactive term of aid and the Burnside-Dollar policy index was not significant. Thus, Islam’s results suggest that aid is only effective when the political situation of the recipient country is stable and vice versa, in politically unstable environments, aid does not have any effect on growth.

Chauvet and Guillaumont (2002) carry out a similar analysis. They estimated a growth model, using data for 53 countries for the period 1975-1999 and included a political instability measure. Chauvet and Guillaumont found evidence for the hypothesis that aid is more effective in politically stable environments, since aid interacted with the political instability variable was negative and statistically significant.

Kosack (2003) also studied whether the effectiveness of aid depends on the political system. In particular, Kosack analysed whether aid is able to improve the quality of life, which is measured by the human development index (HDI). Kosack used a data set for 56 countries, whereby the data was divided into three 4-year periods (1974-77, 1978-81, and 1982-85), and used a simple HDI growth model in which aid to GDP and the interaction of aid to GDP with a measure of democratisation were included, along with a list
of variables generally used in growth models. His results showed that while aid does not generally improve the quality of life, it does lead to higher HDI growth rates when the extent of democratisation is higher. Hence, Kosack concluded that in autocratic countries aid is ineffective, and possibly even harmful and suggested that to make aid more effective, donor and recipient countries should at the same time aim at stimulating democratisation.

Aid and Institutional Quality. Poor countries such as those in Sub-Saharan Africa, Central America, or South Asia, often lack functioning markets, their populations are poorly educated, and their machinery and technology are outdated or nonexistent. However, as argued by Acemoglu (2003) these are only proximate causes of poverty and there must be some fundamental causes leading to these outcomes and via these channels to worsen poverty. Acemoglu (2003) in this study points out two main candidates to explain the fundamental causes of differences in prosperity between countries: geography and institutions. The geography hypothesis maintains that the geography, climate and ecology of a society shape both its technology and the incentives of its inhabitants. It emphasises forces of nature as a primary factor in the poverty of nations.

Meanwhile, the institutions hypothesis, is about human influences, whereby according to this view, some societies have good institutions that encourage investment in machinery, human capital and better technologies, and consequently, these countries achieve economic prosperity. As highlighted by North (1991) ‘institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction’. Thus, institutions have great implications for society because they determine the fundamental structure of human exchange, whether such exchange is political, social or economic.

Acemoglu (2003) argued also that good institutions have three characteristics: (i) enforcement of property rights for a broad cross-section of society, so that a variety of individuals have incentives to invest; (ii) constraints on the actions of elites, politicians and other powerful groups, so that these people cannot expropriate the incomes and investments of others or create a highly uneven playing field; and (iii) some degree of equal opportunity for broad segments of society, so that individuals make investments, especially in human capital and participate in productive economic activities.
These good institutions contrast with conditions in many societies of the world, where the rule of law is applied electively, property rights are nonexistent for the vast majority of the population, the elites have unlimited political and economic power, and only a small fraction of citizens have access to education, credit and production opportunities.

Similarly, Burnside and Dollar (2004) argued that institutional quality is decisive in determining the effectiveness of aid. They investigated this issue with a new dataset, using a single cross section for the 1990s for 124 countries. Their measure of institutional quality was based on a dataset constructed by Kaufmann et al. (1999). This dataset contained an overall measure of institutional quality, summarising various aspects of institutions and policies in one measure. In particular, this measure consisted of four broad categories of variables measuring the institutional environment: government effectiveness, regulatory quality, rule of law and control of corruption. Accordingly, using an instrumental variable technique, Burnside and Dollar found strong evidence that institutional quality determines the effectiveness of aid. While aid was in itself significantly related to growth in this model, the interactive term indicated that institutions matter for aid effectiveness.

Additionally, Bennedsen and Meisner (2005) argue that good institutions create the right incentives for productive activities with a high social and private return, while poor institutions create a market for non-productive activities, such as rent seeking which have a high private but a low social return. Good institutions bring the private return closer to the social return and hence ensure an efficient allocation of resources. More generally, an economic activity, such as an investment in a machine is associated with both a private return and a social return. The private return is the net return that accrues to the agent undertaking the activity, whereas the social return is the total gross return to the economy, that is, the sum of returns to all agents. A tax on profit creates a wedge between the after-tax return (the private return) and the before-tax return (the social return), which lowers the incentives for investing. A risk of theft or expropriation of the return has a similar effect, as it reduces the expected private return relative to the expected social return. Bennedsen and Meisner (2005) argue that productive activities carry a high social return. With good institutions, this return is brought close to the private return. Non-productive activities, on the other hand, are characterised by a low social return, but a high private return as
the aim is redistribution without production. Good institutions can thus cause growth by getting prices right that is, bringing the private return and the social return closer to each other. This encourages productive activities and discourages non-productive activities. Hence, by getting prices right, good institutions ensure an efficient allocation of resources.

Bennedsen and Meisner (2005) try to analyse how do institutions create the right incentives, by considering primarily one of the most important economic institutions, namely the structure of property rights in a society.

Well-defined property rights that are enforced in practice provide incentives for farmers to invest in land and permanent crops and for entrepreneurs to invest in the newest machinery. It also shapes the resulting productivity of inputs, as (i) technological improvements may rely on investments in certain equipment; and (ii) missing property rights may divert inputs to less productive but more secure uses. By the same argument, property rights also provide individuals with incentives to invest in human capital such as specialised education, as the possibilities for profiting from further education increase with more secure property rights.

Another prominent economic institution according to Bennedsen and Meisner (2005) is the presence and quality of markets, whereby when markets work improperly or are non-existent, people do not have incentives to trade. As a result, there exist unrealised gains from trade implying that resources are not allocated where they provide the highest economic contribution. Hence, economic institutions determine who receives the revenues and the profit from production and other activities and therefore have a significant influence on the income distribution in a society.

### Aid and Dutch Disease

The prospect of large increases in the flow of resources from wealthy to poor countries may have undesirable side-effects, particularly those associated with the ‘Dutch disease’ (Meier and Stiglitz, 2001). High and sustained aid inflows may have much the same effect as a natural resource windfall, which can lead to an appreciated exchange rate and wage inflation, and thus to a loss of markets and unemployment in export and import-competing sectors. This effect appeared in the Dutch economy when massive North Sea gas revenues upset the macroeconomic balance – hence the name. The fear is
that high inflows of aid may thus prove to be a ‘curse’ by contributing to a worsening of their export sectors.

Thus, if the Dutch disease scenario were likely, there would be a good reason for fear in the face of large aid flows. It would not only mean that countries may become unable to produce significant amounts of exportable goods, but there may also be very real adjustment costs. For example, cash crop producing farmers who are unable to maintain their livelihood may not easily transform themselves into construction or service sector workers. Thus, such an economy may have large pockets of increasing despair and poverty even as other areas, as well as the broader economy, appear to be doing well. Yet despite its prominence in the development literature, there is no explicitly documented case of aid induced Dutch disease. Some researchers have found cross-country evidence suggesting that very large increases in aid may lead to slower growth of export sectors, but no single-country study has been able to demonstrate a link between large increases in aid inflows and a contraction in tradable goods producing sectors. While this evidence does not amount to a refusal of the hypothesis, it does suggest that the fear is exaggerated.

**Aid Harmonization and Alignment**

Aid harmonisation is another factor associated with aid effectiveness, in that very often donors do not coordinate and align their efforts, leading to fragmentation and high transaction costs.

Against this background, in 2003 the Rome Declaration on Harmonisation identified the need to harmonise the operational policies, procedures and practices of donor institutions with those of partner country systems to improve the effectiveness of development assistance and thereby contribute to meeting the MDGs. According to Balogun (2005) this declaration is a response to the growing evidence that, over time, the totality and wide variety of donor requirements and processes for preparing, delivering and monitoring development assistance are generating unproductive transaction costs for, and drawing down the limited capacity of, partner countries.

Balogun (2005) argues that immediate benefits of increased aid harmonization and alignment are a reduction in transaction costs and a general increase in
the efficiency of management of aid delivery for both donors and recipient governments. The increased efficiency benefits to partner governments are then assumed to feed through an increase in the quality of management of governments’ own policy, planning and budgeting processes, which ultimately leads to faster economic growth.

In addition, according to the 2008 Survey on Monitoring the Paris Declaration (OECD, 2008), which assesses progress made in 55 partner countries and analyses the challenges in making aid more effective at advancing development, progress is being made, but not fast enough. This Survey highlights that unless partner countries and external partners seriously gear up their efforts, they will not meet their international commitments and targets for effective aid by 2010. The Survey indicates that 36 per cent of partner countries showed improvements in the quality of country systems for managing public funds. Additionally, aid to partner countries was found to be increasingly untied, whereby the proportion of untied aid increased from 75 per cent in 2005 to 88 per cent in 2006.

Donor technical co-operation was found to be more coordinated and aligned with the capacity development programmes of partner countries as the proportion of coordinated technical co-operation increased from 48 per cent in 2005 to 60 per cent in 2007, exceeding the 2010 target of 50 per cent. Yet the evidence from the 2008 Survey is also clear that the pace of progress is too slow. Without further reform and faster action, the 2010 targets for improving the quality of aid will not be met (OECD, 2008).

Accordingly, the Survey puts forward three recommendations aimed at strengthening the capacity of aid to promote development. The recommendations indicate that governments and donors should work together to: (i) systematically step up efforts to use and strengthen country systems as a way of reinforcing country ownership of aid; (ii) strengthen accountability for development resources; and (iii) curb the cost of delivering and managing aid. (OECD, 2008)

Conclusion

Since the 1960s, aid theory has developed and this has led donor organizations to change the profile of their spending. In the 1960s the dependency theory
was popular, and filling the savings gap was a major motive of ODA. In the 1980s, the World Bank promoted ‘structural adjustment’ lending, the objective of which was to adjust economic structures and policies in poor countries to steer them towards economic development. In the 1990s, the trend was to emphasize conditionality, better selectivity and the policy environment in the recipient countries, in theory as well as in practice. During the first decade of the 21st Century, aid harmonisation between donors was identified as a major requisite for aid effectiveness.

The foregoing discussion indicates that aid may not always be successful in promoting economic growth - however good institutional and policy frameworks enhance aid effectiveness and this remains a paramount requisite for improving the prospects that aid is transformed into economic growth. In fact, there is a growing awareness that aid itself can be instrumental in promoting good economic governance, which in turn leads to improved aid effectiveness.

References


