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Another Look at Foreign Aid

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Abstract

The discussion of the effectiveness of foreign aid has reached a high pitch. This paper assesses the sorry past and present key arguments for a potentially more effective and sustainable method of aid delivery. A key ingredient is to shake off the vestiges of structural adjustment and move towards true recipient country ownership complete with "self-conditionality" with aid recipients formulating their own reform packages. This means donors become much more passive, act like a bank and respond to proposals which concentrate on a few critical areas over a three to five-year period. Policy-based program lending should respond to packages put together by the main domestic stakeholders with the help, if necessary, of independent third parties. There should be no compulsion to lend; indeed, an aid hiatus is an indication that the new system is effective. What is required is for donors to stop using aid as a short-term foreign policy tool and for recipients to accept the notion that aid provides the opportunity to reduce the inevitable adjustment pains caused by real reforms.

Key words: Foreign aid, self-conditionality, program lending, new donors

JEL Codes: 011. 020, 038, P45

I. INTRODUCTION

The foreign aid landscape has undergone a paradigm shift in the last few decades, with changes in the behavior of "traditional" donors and a new focus on selectivity in aid disbursement, as well as "new" donors and South-South cooperation playing an increasingly important role. Amidst these changes the debate over aid effectiveness rages on. What impact has aid had on recipient countries, and does aid really have the ability to induce policy reform? The structural adjustment loans of the 1980s were an attempt at prompting policy reform by imposing conditions on recipient countries. This proved ineffective for a number of reasons, and the aid community continues its search for the elusive "silver bullet" in foreign aid provision. This paper assesses the past effectiveness of aid, comments on new aid donors and outlines some of the key arguments in favor of a potentially more effective and sustainable method of conditional aid delivery.

II. HAS AID BEEN EFFECTIVE?

Foreign aid, a term encompassing a wide range of activities ranging from bilateral direct budgetary assistance to smaller NGO-led projects, is a constantly contentious topic in the development community. While there is little doubt that development aid has had its successes with improving the lives of impoverished populations around the world, discontent with the current aid system has become increasingly universal, with criticisms often coming from the same authors who also acknowledge the potential benefits of aid.

Economic growth is considered by many to be a pre-requisite for poverty reduction. However, the links between poverty reduction and growth are extremely complex, and growth does not always result in poverty reduction. Poverty reduction dependent on the trickle-down effect of wealth in a growing economy is very fragile and does little to change the structural reasons behind poverty. Inequality matters – growth might benefit the rich a lot more than the poor in countries with high inequality.

The link between aid and growth is also complex. Isolating the effect of aid on GDP growth is difficult and fraught with contention. Since a salient feature of aid has been conditionality, the question of whether aid has led to growth primarily involves testing whether policies along the lines of the Washington Consensus have led to growth or not.

Three schools of thought typify the debate over aid effectiveness:

1. (More aid) While aid appears to have been of limited effectiveness to date, this is due to the fact that insufficient aid has been disbursed thus far. Scaling up aid will result in more economic growth and poverty reduction. The solution to improved aid effectiveness from this point of view is hence an increase in the quantity of aid. Jeffrey Sachs is one of the most vocal proponents of this point of view.
2. (Problem aid) Contrary to its stated objectives, aid has done great harm, or at best has had little or no effect on recipient country economies. Proponents of this view believe that aid has lost its relevance in the modern economy and should be reduced, or eventually stopped altogether. Outspoken aid critic William Easterly is a proponent of this point of view.
3. (Middle ground) The effectiveness of aid depends on the conditions under which it is disbursed – for example, factors such as a better policy environment and good governance are a necessity for aid to result in higher levels of economic growth. In the absence of these, aid might have insignificant or even negative effects on the recipient country's economy.

<u>More aid</u>

Aid Statistics

Global aid levels had been rising for almost a decade before 2011, which saw a trend-bucking decline in foreign aid in the wake of the global financial crisis. Aid flows from Development Assistance Committee (DAC) donor countries totaled USD 129 billion in 2010, the highest level ever, and an increase of 6.3 percent in real terms over 2009. However, 2011 saw a -2.7 percent drop in real terms compared to 2010, with official development assistance (ODA) totaling USD 133.5 billion.

The United States remains the world's largest donor and has led the way on aid increases, with net ODA disbursements of USD 30.2 billion in 2010, representing an increase of 3.5 percent in real terms over 2009. This is the highest real level of ODA ever recorded by a single donor country. In 2011, net ODA flows from the US amounted to USD 30.7 billion, representing a fall of -0.9 percent in real terms from 2010. At the Financing for Development conference held in Monterrey in 2002, President George W. Bush promised a 50 percent increase in US development assistance by 2006, and achieved that level three years before the target. President

Bush quadrupled aid to Africa between 2001 and 2006, from $1.4 billion to $5.6 billion a year (Glennie, 2008). However, continuing tight budgets both in the US and in other OECD countries will put pressure on aid levels in coming years.

The report of the UN Millennium Project, directed by economist and aid advocate Jeffrey Sachs, called for aid to all developing countries to rise to $195 billion by 2015, from $80 billion in 2005. However OECD projections suggest slower aid growth ahead, with global country program aid slated to grow at a real rate of 2 percent per year from 2011 to 2013, compared to 8 percent per year on average over the past three years.

The disbursement of aid, and hence the calls for aid levels to increase, has traditionally been justified on the grounds that recipient countries are in dire need of economic development and poverty reduction, and lack their own resources (both fiscal and social) to implement the necessary economic and political reforms. This is inextricably linked to the moral argument often put forward. Given the massive inequalities in today's global income distribution, developed countries are technically in a position to help those who have not been as fortunate.

In the field of healthcare, foreign aid's most dramatic successes have occurred. Aid played a central role in the eradication of diseases such as smallpox and polio, as well as in immunization, where significant achievements were paid for in large part by aid money, bypassing government health systems and going directly to people who most need urgent help. Examples of programs and organizations include the President's Emergency Plan For AIDS Relief (PEPFAR), a commitment of $15 billion over five years (2003–2008) from US President George W. Bush to fight the global HIV/AIDS pandemic, and public-private partnerships such as the Global Fund to Fight AIDS, Tuberculosis and Malaria (often called The Global Fund) and the GAVI Alliance (formerly the "Global Alliance for Vaccines and Immunization"). Beyond healthcare, the development of high-yielding crops was a success. Notably, these were projects with narrowly defined objectives and clear targets. Due to the chronic shortages in the public purse in poor countries, aid has also been an important source of cash in funding public services.

In addition to infrastructure, aid could potentially also have positive effects on governance in recipient countries. Good governance can be defined as the institutions that establish a predictable, impartial and consistently enforced set of rules for investors. Low government revenue could be a binding constraint on the development of well-functioning bureaucracies and legal systems, and foreign aid can be used for improved training and increasing salaries for public employees such as police, judges, tax collectors, etc. Aid also sometimes takes the form of programs intended to strengthen the legal system, public financial management and other responsibilities of the public sector. In recent years multilateral institutions such as the World Bank, the IMF and bilateral donors such as USAID have made governance reforms a priority. It is assumed that aid could improve the quality of governance through conditionality, which will be elaborated on subsequently.

For many years, the standard model used to justify aid was the "two-gap" model of Chenery and Strout (1966) - The first gap is between the amount of investment necessary to attain a certain rate of growth and the available domestic saving, while the second gap is the one between import requirements for a given level of production and foreign exchange earnings. At any moment in time, one gap is binding, and foreign aid fills that gap. It was argued that foreign aid could play a role in relieving these constraints and could eventually promote a level of investment that would enable the country to attain self-sustaining growth. However this model has been criticized on various grounds, with several critics highlighting the lack of theoretical or empirical justifications for assuming a short-run proportional relationship between growth and "investment requirements", or the assumption that filling a "financing gap" determined by "investment requirements" will raise investment or growth in the short run. The proposed "three stages of growth" in the Chenery-Strout model have also been criticized on the basis that it represents a very specific view of the economic transition of a developing country. Regardless, this model wielded much policymaking clout and was often used, implicitly or explicitly, as the justification for aid disbursements.

Despite the widespread dissatisfaction with the current aid system, all of the main actors in the international aid community appear to agree that the volume of aid disbursed to less developed countries has to increase. After stagnating in the 1990s, foreign aid indeed increased significantly in the new millennium, though it has declined slightly in recent years. It remains to be seen how quickly the developed countries will recover from the aftereffects of the global financial crisis and for aid levels to begin rising again.

Problem aid

Just as there are many examples of aid supporting initiatives that have done a lot of good, there are also many examples where interventions supported by aid have not done much good, but indeed actively harmed the welfare of the poor. Controversial aid projects are often ones that focus not on bringing social benefits to people directly, but on boosting the economy. For example, dams that provide energy but lead to mass displacement, roads that help some economic sectors but cut through virgin forests etc. Donors often do not allow for the possibility that the aid will do more harm than good, usually embracing the attitude that while the aid may not be perfect it will at least do some good.

William Easterly, one of the most outspoken critics of current aid modalities, maintains that one of the main problems with foreign aid is the disjoint between the amount of local knowledge that (mostly well-meaning) donors have, and the actual situation on the ground in recipient countries. Easterly highlights the distinction between the “Planners” in foreign aid, typically large aid agencies and developed-country donors, who attempt to impose top-down interventions on recipient countries. He argues that historically, poverty has not been diminished by such central planners but by “Searchers”, who explore solutions by trial and error and make piecemeal improvements to the economy based on what has been found to work. Easterly’s view is that the current aid system has been driven by the decisions of Planners, who attempt to “make poverty history” with grand efforts at international collective action and scaling up current quantities of aid, based on the belief that higher levels of aid will yield better results.

Indeed, the notion that “aid buys growth” is an integral part of the ideology and ongoing mission of aid bureaucracies. This emphasis on the quantity of aid disbursed is understandable given the nature of the aid mechanism – evaluating the effectiveness of aid interventions has until recently not been a priority, and the quantity of aid disbursed is often used as a measure of an agency’s success in “reducing poverty” or advancing some social cause in a developing country. The UN’s campaign to double aid worldwide by 2010 rested largely on the idea that low levels of aid (rather than government policies or behavior) had been a central reason for the failure of the poorest countries to grow. However, the effects of aid on economic growth are notoriously difficult to measure, and it is unclear whether or not more money is really going to improve a country’s dismal record. The fact that some aid has been effective is also not particularly encouraging. It would be difficult to have spent so much money without doing some things right. The aid agencies themselves operating in this difficult environment do not have much incentive to achieve results, since the results are often unobservable – for example, one can hardly monitor growth itself for a given country for a given year, since growth in any given year or even over a few years reflects too many other inputs besides aid.

Moreover, the governments of developed countries who have been behind most of the aid that has been disbursed are typically not driven by purely altruistic motives. Beyond helping the poor, aid is more often than not used as a foreign policy tool. Altruistic motivations are based on humanitarian interest in a recipient's development, with aid targeted to countries that can use the money most effectively. On the other hand, strategic motivations are associated with the donors' short term and long term political and economic interests, with foreign policy interests trumping "need" as a determinant of allocation levels. Since bilateral aid is often given as a result of donors' political and economic interests, we can surmise why aid has not always been effective at spurring development. Strategic donors do not necessarily allocate aid based on the development it could create but rather on the political cooperation it could encourage. However, it should be noted that the strategic allocation of aid is not a death knell for aid effectiveness, since it is still possible for aid given to strategic partners to be well-allocated and prudently used.

As an example of strategic aid allocation, the largest recipients of US aid are those countries seen as "strategically important", and evidence suggests that the World Bank and IMF have usually followed US strategic priorities, since the US is the largest shareholder of both institutions. The US has made use of aid in Cold War foreign policy, the war on terror and also used aid to buy UN votes for the war in Iraq. In the new era of aid, a small number of donors, especially in Europe, have been focusing their attention on the poorest countries. However, this remains the exception and not the rule, and there are strong indications that any movement towards seeing aid as separate from foreign policy objectives is not shared by the US. It is clear that the US' short to medium term interests are still that countries should be stable enough to reduce potential threats, rather than transformed enough to reduce poverty. In the words of Andrew Natsios, head of USAID in 2005, "civilized life depends crucially on transforming the troubled regions of the world…opening up the developing world to economic opportunity and expanding the ranks of democratic states…vital to US national security".

Another possible problem that might arise with aid is Dutch Disease. Aid is a transfer of foreign currency, and some combination of the following might potentially occur: (a) a shift of production from exports to non-tradable goods, which are then consumed locally; (b) a shift of production from import substitutes, allowing for goods and services to be imported instead of produced locally, thus freeing up domestic resources; (c) Additional imports, which add to local consumption, and were not affordable without aid. The first two are together known as Dutch Disease. Aid permits higher consumption of non-tradable goods than was possible without aid, by switching productive resources into such non-tradable goods. A country generally experiences appreciation of the real exchange rate as it industrializes, and long run appreciation of the real exchange rate is driven by a rise in productivity, output and incomes. However, appreciation resulting from aid inflows is different: aid causes an immediate appreciation of the exchange rate before there has been an increase in productivity and output. This can have harmful effects resulting from a potential decline in exports, and the fact that aid finances a level of consumption and investment that is higher than the country's economic output would permit.

There is a second strand of Dutch Disease that could potentially be more worrying - namely, the impact of aid on decision-making. An external source of fund can encourage the persistence of inappropriate policy regimes. Instead of facilitating reform, aid in fact can take the pressure off the need to reform, leading to lower domestic savings, rent seeking, corruption, and capital flight. Despite recent attempts in the "new era of aid" to condition aid disbursement on "good governance", aid itself has the potential to weaken government accountability by retarding the development of a healthy "civil society" underpinning democracy and the rule of law. Foreign aid may short circuit the processes necessary to build up these institutions by reducing government's dependence on its citizenry for tax revenues, with politicians feeling more accountable to foreign donors than to their own taxpaying citizens. Aid can even increase political instability by making control of the government a more valuable prize. Foreign aid represents a potential source of rents - rent seeking often takes the form of increased public sector employment, large government subsidies to state-owned enterprises etc. Governments might devote more resources to obtaining political influence in order to gain more access to the rents from foreign aid, and reallocate talent and resources away from productive and towards redistributive activities. Aid funded projects have been accused of weakening the bureaucracies of recipient governments by siphoning away scarce talent from the civil service and hence hindering the development of local administrative capacity and effective public services.

Given the proliferation in the number of donors in the international aid community, aid coordination has become an extremely pressing issue. Each recipient country has to deal with a multitude of donors, including multilateral agencies, bilateral donors and NGOs, each with their own agendas and methodologies. Large numbers of donors and projects overwhelm the recipient government's capacity to manage and administer aid inflows. The immediate consequence of aid proliferation is an increase in transaction costs incurred by recipient governments. Aid proliferation also results in project duplication and the development of parallel infrastructures for delivering similar outcomes, which is a waste of resources. Empirical results are in favor of the hypothesis that aid proliferation has a negative effect on the economic growth of recipient countries, especially in Africa (Kimura, Mori and Sawada, 2012). These authors conclude that if aid coordination leads to aid concentration by reducing transaction costs, then it may promote economic growth; however if the proliferation problem arises from a free-rider problem among donors, aid coordination may not facilitate growth.

One approach that donors have taken in an attempt to make aid more effective is implementing projects instead of providing general budget support to governments, based on the justification that projects will bypass ineffective and corrupt governments and reduce the discretion of recipient countries in terms of how to spend the money. Radelet (2004) writes, "in weak, failing and poorly governed countries, donors should retain a strong role in setting priorities and designing programs." Indeed, principal-agent theory suggests that the greater the divergence between a donor (the principal) and the recipient country (the agent), the more control the donor should have over how the money is spent. However, project aid has had disappointing results. Aid that finances projects is still fungible, in the sense that it frees up government money for spending on other items, possibly of dubious economic functionality. In addition, there has been evidence to suggest that projects in poor policy environments often fail (Easterly 2002), for example, constructing rural roads in a country where they will not be properly maintained or where government policies are unfriendly to agriculture is likely to be ineffective in spurring economic growth.

The fungibility of aid - development assistance not being used for its intended purposes – continues to be a concern. In the fungibility literature, there seems to be a fairly wide support that, in general, sectoral aid tends to be fungible. This implies, that at the margin, sectoral aid usually finances something different from what donors intended. Feyzioglu et al. (1998) and Swaroop et al. (2000) reach the conclusion that aid should therefore be tied to overall public expenditure programs that provide resources to crucial sectors, with a similar conclusion reached by the World Bank in a summary of a number of articles on fungibility. Since government and community ownership of projects is crucial, and since there is little hope of reaching consensus on spending priorities, donors should instead simply take for granted that their financing is fungible, and "help support the creation of an environment for productive public expenditures". Alternatively, they may redirect aid towards more well-managed countries. However, Devarajan et al. (1999) point out that even when preferences between donors and recipients differ, it is still not clear whether the presence of aid fungibility has positive or negative effects. It all depends on what the government does with resources released by the aid projects. Reducing aid to countries that are highly aid dependent and where aid is fungible would be equivalent to a decrease in the country's own resources, with potentially detrimental effects. It also points to the importance of the quality of the overall public expenditure program of recipient countries.

Middle ground - Aid is effective under certain conditions

The school of thought that has been most influential in current policy discussions about aid is based on the belief that aid is effective only under certain conditions, for example in the presence of "good governance", and is harmful or ineffective otherwise. The seminal paper by Burnside and Dollar (2000), which shows that aid has a positive effect on economic growth in the presence of policies that promote trade openness and political freedom, has had a great deal of policy influence.

Based on theory, it is quite plausible that aid would promote growth in poor countries that manage to put good institutions in place. Possible case studies include the Marshall Plan after World War II, where significant amounts of finance were pumped into an environment of solid institutions and social infrastructure. Part of the Plan's success was the fact that recipient governments were subject to a system of mutual peer review that forced them to explain what they would do with their Marshall Plan aid. An allocation of aid was arrived at through the peer review process, which did not involve the United States (the donor). The resulting positive effect on recipient countries disproves the hypothesis that aid is always money down the rat hole.

Interpreting the causal effect of aid on growth is inevitably difficult, since there are many actors and more aid is typically given in response to slower growth. Some papers confirm the message of Burnside and Dollar that aid only works in a good policy environment, while others find that when other variables are added, the coefficient on the interaction between aid and policy becomes near zero and/or statistically insignificant. For example, Easterly, Levine and Roodman (2003) using a different time period in their regressions and a different measure of "good policy" found that the coefficient on the crucial interaction term between aid and policy was insignificant in the expanded sample including new data, indicating no support for the conclusion that "aid works in a good policy environment." This and other results indicate that the empirical links from aid to economic growth are far more fragile than the drumbeat of media and development agency references to the Burnside and Dollar (2000) paper suggest. There has been as much evidence that aid has an insignificant impact on growth as evidence that its impact is significant -

Clemens et. al (2004) find that the impact of certain types of aid on growth is very significant and does not depend on the recipient's policy environment, while Rajan and Subramanian (2005) find little robust evidence of a positive or negative relationship between aid and growth.

Despite the fact that there is little agreement in the academic community about the role of good policy in determining the effect of aid on economic growth, "selectivity" has become the new buzzword in the international aid community. Changes in the international aid architecture have prompted donors to become increasingly selective with regards to the countries to which they provide aid. Examples of recent changes in aid architecture, such as the Heavily Indebted Poor Countries (HIPC) debt reduction initiative and the PRSP (Poverty Reduction Strategy Paper) process, are examples of this greater selectivity. Over time the role of poverty in countries' policy and institutional environments for aid allocation has increased. Burnside and Dollar (2004) find that in the 1980s, there was no significant relationship between the quantity of aid disbursed and either the rule of law or democracy, indicating that the allocation of aid was not correlated with institutional quality, as measured by the International Country Risk Guide (ICRG) rule of law index and the Freedom House democracy index. However, they find that aid is positively correlated with institutional quality in the 1990s. Where there are countries of equal poverty and population but differing institutional quality, the country with better institutions received more aid, which was not the case in the 1980s.

Aid, if effectively designed and deployed, can be a powerful incentive for reform in recipient countries. Donors can influence the policy agenda and development policies adopted by recipient governments by linking support to specific developmental or reform activities. For example, the Millennium Challenge Corporation, a bilateral US foreign aid agency established in 2004, only works with "well-performing" countries that satisfy a series of minimum standards in three areas: ruling justly, investing in people and economic freedom. Conditions typically include macroeconomic stability (low-budget deficits and inflation), noninterference with market pricing, privatization of state- owned enterprises and openness to international trade, among others.

A World Bank report (Collier and Dollar, 1998) estimates that if aid is redirected towards poor countries with good policies, more than twice the number of people could be lifted out of poverty for the same aggregate level of foreign aid. Consequently, there appear to be large potential gains from effective aid conditionality.

Almost all of the High Level Fora on Aid Effectiveness (Paris, Accra, Buzan) have emphasized the need to promote country ownership in the disbursement of foreign aid. In an ideal world where the aid mechanism functions perfectly, aid conditionality would be the primary means through which local governments and citizens in recipient countries take ownership of the aid process in their own country, with the eventual long-term objective of no longer being aid-dependent. In an ideal world, therefore, the conditions imposed by donors would be effective, country-specific and feasible, and it would be in the best interests of recipient countries to implement these policy suggestions. Recipient country governments who successfully fulfill the conditions will be rewarded with aid disbursements and strong economic growth, while those who fail to do so will not.

It is clear, however, that the above situation has generally not come to pass. Regardless of donor intentions, the conditions imposed by donors – for example through the World Bank structural adjustment loan process, the PRSPs or through other multilateral or bilateral processes – are often not met, yet the funds are disbursed regardless. In addition, it is doubtful that policy suggestions are always made in the best interests of recipient countries.

Increasingly, aid money is being selectively directed to countries that meet the condition of having “good policies”, however these might be defined. The “new selectivity” is supposed to be about rewarding countries that reform on their own, in contrast to structural adjustment that is now alleged to have imposed reforms on countries. In both cases, aid and concessional loans are selectively available to countries that meet conditions, so if any practical difference exists, it is extremely subtle.

In fact, studies have largely concluded that conditional aid has no systematic influence on policy (Easterly 2005; Alesina and Dollar 2000). The reasons for the failure of aid conditionality lie on both the recipient side and the donor side of the aid equation. Among recipient countries, strong internal socio-political forces are often in place that are opposed to the effective implementation of policy conditions, based on the assumption that the policy would already be in place if this were not true, and conditionality would hence be unnecessary. As a result, policies implemented in response to conditionality requirements are often reversed or simply ignored in practice.

On the donor side, the fundamental problem remains that both the success of past aid conditions in prompting reform and the failure of past aid conditions in prompting reform are taken as justifications for future aid, which means that the imposition of conditions turns out to be more a strategy of wishful hand-waving than a policy with consequences. Indeed, using data from around 200 structural adjustment programs, Svensson (2002) finds no link between a country’s reform effort, or fulfillment of ‘‘conditionality’’, and the disbursement rate.

Svensson (2002) also highlights a complementary issue that impedes the effectiveness of aid conditionality – the budget-pressure problem. In most donor organizations, the allocation and disbursement decisions are separated. While the aid allocation process is centralized, the disbursement decision is decentralized (country- or project-specific). This setup has resulted in a strong bias towards ‘‘always’’ disbursing committed funds to the ex ante designated recipient, quite irrespective of the recipient government’s performance. Thus, resources are not shifted towards countries where reforms actually take place, and ‘‘threats’’ of not disbursing committed aid if the recipient fails to reform are not credible. The bias, in turn, arises because the opportunity cost of a given aid budget (or a committed adjustment loan) for the disbursing donor agent is low.

Studies of bilateral donor organizations have emphasized that, in practice, ‘‘spending the budget’’ has become a key goal in itself. Since the allocation of the overall aid budget across country departments is partly determined by the disbursement history, a country department failing to disburse the committed funds will most likely receive a smaller allocation the following year. Mosley et al. (1995) argue that the World Bank’s country loan officers are under intense pressure to meet country disbursement targets notwithstanding how unpromising that government’s subsequent implementation performance is. In addition, they highlight a coordination/free-rider problem. Keeping in mind what other countries have got away with, World Bank officials know that it will not be financially productive to make an example of one particular recipient who defaults on conditions by refusing to disburse the committed funds. Moreover, the enforcement of conditionality might be in conflict with other goals of the Bank, such as providing quick-disbursing finance so as to hinder a potential default on outstanding loans.

Foreign aid can also result in political deterioration in the recipient country as a result of weaker government accountability. Such arguments generally center on the willingness of governments that receive foreign aid to reduce taxation of their citizens. Taxation is often thought to have played a key role in the development of Western representative institutions. For example, governments in the Middle East oil-dependent states have resisted pressures to democratize, helped by the fact that they do not need to tax their citizens to obtain revenue. Like any windfall to governments, foreign aid reduces the importance of domestic revenue and therefore the vital “social contract” of accountability between the government and its people. At the same time, citizens who know that policies are made to please donors will spend less time trying to pressure their governments to change. Morrison (2009) argues that the institutions in place in a country determine how non-tax revenue is going to be used, given that the incumbent government has discretion over aid monies. Morrison shows that non-tax revenue generated by state-owned natural resources is associated with a lower probability of a regime transition in both democracies and dictatorships. Given that foreign aid can be seen as a form of externally generated non-tax revenue similar to natural resource rents, aid can also have the effect of solidifying whatever political regime is in place.

The lasting impact of policy conditions is probably greater than that of the actual financial resource transfers associated with them. It is clear that most aid recipient economies, especially those in Africa, have changed very significantly along the lines of the Washington Consensus since the 1980s. In practice the tenets of the Washington Consensus were applied so rigorously and without regard for political context that they generated many negative outcomes for recipient countries. Other policies being forced on recipient countries are highly controversial and might lead to lasting damage. In the words of Joseph Stiglitz, “there is no consensus except that the Washington Consensus did not provide the answer”.

Regardless of how much ownership in foreign aid is emphasized, conditionalities have reached to the very heart of basic policymaking in many recipient countries, from stipulating how to deliver basic services like health, to deciding how political systems should be structured. Donors have effectively influenced recipient government policy for decades. Ironically, the policy conditions requested by donors have not always been in the best interests of recipient countries. Primary among such policies has been trade liberalization. Many recipient countries have reduced tariff and quota barriers in response to aid conditionality demands. Such tariff reduction have sometimes led to the devastation of important industries, for example in Kenya. When trade barriers were removed, cotton exports from Kenya had to compete with underpriced US cotton, which led to years of underinvestment in the Kenyan cotton industry and exposure to distorted and volatile global markets. Tariff reduction also affects the size of national budgets and the amount available for spending on development, since import tariffs are administratively one of the easiest taxes to impose. Another common conditionality is the reduction of state subsidies to important economic sectors. In Senegal, the government privatized the collection and sale of the groundnut harvest and the distribution of groundnut seeds in response to donor pressure, leading to huge losses for farmers who received far less for their crops.

Some have argued that aid conditions are not to blame for the wholesale shift in direction of Africa's economic and social policies, and that African governments must take responsibility for their decisions. This argument does contain an element of truth, since African governments have occasionally fought off pressure from donors to implement reforms they oppose. However the story in aid-dependent countries has usually been one of subservience to donor demands. From such a large and diverse group of aid recipients one would expect an equally large and diverse range of responses to the various problems of poverty and development. Instead, the responses have very much fitted the blueprint designed in Washington. Selectivity in aid disbursement can therefore be seen as a more subtle way of pressurizing governments into implementing certain policies; only this time the policies need to be implemented in advance of receiving aid, rather than during the period of aid disbursement.

An Effort at Reform

In an attempt to strengthen the links between poverty reduction, growth and debt relief, the World Bank and IMF introduced the Heavily Indebted Poor Countries (HIPC) initiative in 1996. The initiative aimed to grant debt relief to countries conditional on structural reforms, and required from eligible countries suggestions for policy change in the form of Poverty Reduction Strategy Papers. The Poverty Reduction Strategy Papers (PRSPs), intended to be more participatory than previous efforts, are documents that outline the government's poverty reduction policies, and are drawn up in consultation with NGOs, the private sector, civil society and other important stakeholders.

This strategy has been justified as an attempt to change the institutional environment surrounding foreign aid, by encouraging recipient countries to take ownership of their own reforms and have the donor community play a supporting role. Many saw this as an important step towards country ownership of aid conditions, and indeed there have been some positive experiences with the PRSP approach. In Ghana, civil society successfully influenced the PRSP towards a focus on the especially poor areas of the country. In Zambia, discussions with key stakeholders shed light on the harm being done by rapid agricultural liberalization and led the government to re-introduce support for some sectors.

In general, however, donors have not respected the PRSP process. Of the 20 countries with PRSPs completed by March 2003, 16 had previously agreed to IMF programs, prior to the completion of the PRSP. Indeed, in what is ostensibly a recipient-led process, the international financial institutions continue to play a significant role in determining the nature of the reforms and provide instructions on how the PRSPs should be prepared. For instance, the World Bank distributes a Sourcebook for Poverty Reduction Strategies that is intended to serve as a guide to recipient countries on how policies towards such issues as public spending, environment and gender should be formulated. In addition, donors remain in the position to pick and choose which items on the list they will support, while claiming to be supporting government priorities.

In practice, the PRSPs have involved less "ownership" than advertised, with the process coming to resemble the structural adjustment programs of the previous aid era, which the aid community has agreed were far from successful. Both are negatively affected by the fact that both donors and recipients have an incentive to put together a list of reforms simply so the aid can be rapidly disbursed. IFI staff and loan recipients are similarly motivated - the former seeing their rewards and promotions in terms of the volume of aid disbursed, the latter in terms of the relief expected from the rapid disbursement of money.

Indeed, the IFIs themselves have acknowledged the problems inherent in the PRSP process. The PRSP *Progress in Implementation* paper prepared in 2003 for the Bank/Fund Annual Meetings indicated that the PRSP process is charged with multiple objectives, many of which are in tension. This "inevitably means that PRSPs will reflect compromises". The report expresses concern about the extent to which government and civil society have been actively involved in creating and debating strategies. Also, it states that "the government took a material lead in donor coordination in only three of the 48 PRSP countries studied", and cites evidence that priorities are being motivated by the supply of donor financing rather than deriving from newly articulated national policy agendas.

One major problem was that these programs were never truly 'owned' by the recipient countries and that, consequently, the entire process came to resemble a "ritual dance". Donor agencies have internally-generated incentives to disburse funds, and are unable to commit to withholding the money should the recipient not comply with the stated conditions. At the same time, recipient countries face large obstacles to reform, and base their expectations on observations of previous instances under the structural adjustment framework in which funds were disbursed to countries that did not fulfill conditions. Both parties end up simply going through the motions of preparing for reform. The end result is a situation in which both the recipient and donor are fully aware of the eventual outcome from the outset – that the funds will be disbursed regardless of the actions taken by the recipient.

III. THE APPROACH OF NEW DONORS

An entirely new set of countries and multilateral agencies now provide aid, including bilateral donors who are not part of the OECD, e.g. China, Arab countries, India, and an increasing number of multilateral aid organizations. The types and categories of aid-funded projects have also changed. Through the 1990s major donors provided a significant portion of their aid for infrastructure. However since 2000 infrastructure aid from DAC donors has dropped off considerably and has constituted an average of just 10% of total DAC bilateral aid. Non-DAC donors' continuing interest in infrastructure, however, offset the sharp decline of DAC donors' support of such projects.

Developing countries such as China and India are said to have a different approach to recipient governments and with respect to policy dialogue, because they know how it feels to be on the recipient side of the aid relationship, even though aid has played a minimal role in the economic development of both countries. China and India are also more appealing to recipient governments because they themselves are economic success stories, which achieved formidable development goals over the past decades. Both donors are known for being "pragmatic" and do not sign on to agreements about aid modalities which tend to be dominated by major donor countries. Indeed, India and China do not have a clear and prescriptive idea of what "good policy" is, in contrast to the much-vaunted "selectivity" of the traditional donors. The greater involvement of China, India and other emerging donors in aid recipient countries enhances the leverage of recipient governments in choosing with whom to partner, for example if they wish to avoid aid conditionality.

Chinese aid has doubled since the late 1990s and consists primarily of project aid, technical aid, humanitarian and multilateral aid. There are doubts about the size of China's aid program, since there is often no clear distinction between aid, trade and investment. Various sources have put the figure between $1 and $2 billion, with aid to Africa about half of that. The share allocated to Africa in total Chinese aid has increased in recent years.

Increasingly China has also become an important investor abroad, with investments made by both private and state companies and supported by government policy. The link between aid and economic interests has always been much stronger for China than for "traditional donors", or at least much more explicit. China's investments in developing countries is strongly shaped by China's long-term strategic interests in raw materials, energy and food security. Trade between

China and Africa has been increasing rapidly, to over $100 billion in 2008, making China Africa's third largest trading partner. China's main imports from Africa include oil and gas; and its main exports include machinery, vehicles, textiles and manufactured products.

China is complementing hard economics and global politics with carefully designed and internally negotiated "soft power", including through a resurgence of international aid. Aid from China tends to be connected to commercial activities, for example infrastructure projects. Most international commentators agree that China's focus on infrastructure fills a gap left by old donors. China's aid is also primarily bilateral, and is made up of a combination of grants, concessional loans, and debt relief, project investments, training and technical assistance. Instead of ex ante conditions, China has a budget for a country and then agrees with the government on how the money is spent. The absence of political conditionality (which according to Chinese officials does not foster development) and China's recent domestic economic success helps it win the trust of recipient governments. Chinese aid also does not change much from year to year, unlike that of the more traditional donor community, with its shifting aid fashions and fads. Some of the challenges still facing Chinese aid policy, however, include issues with governance and corruption, debt sustainability and the necessity for transparent aid practices.

Chinese views stress the continuity of its aid program since the period of Chairman Mao. China's foreign aid to Africa has amounted to 44.4 billion RMB implementing about 900 projects on infrastructure construction and social services provision since it started providing aid to Africa in 1956. The aid program was re-developed in the 1990s with China's rapidly growing economic interests in the African continent, particularly in the resource-rich economies. China's current international strategy is framed in a language of brotherhood and non-interference, providing an alternative to the post-colonial relations particularly of European countries. China's support for particular countries, notably "fragile states" like Cambodia, Congo and Angola, does provide an alternative to the support that comes with heavy conditions of the old donors. The aid program has become part of the "soft power" that China employs in its foreign policy dealings.

While recent debates often stress the distinctiveness of China's aid program, many of its characteristics find clear similarities with "old donors". China's emphasis on non-interference is often held up as a distinctive trait, but old donors too have increasingly emphasized that it is up to the recipients to define the uses and objectives of aid. China does not officially sign up to an OECD (Paris) consensus, for example with respect to budget support and conditionalities, but it is useful to note that very few "traditional" donors now end up supporting the implementation of these conditions.

IV. LOOKING AHEAD – A SUGGESTED STEP FORWARD

Self-conditionality

For conditional aid to become more effective, the aid community has to shake off the vestiges of structural adjustment and token “recipient country ownership”. Aid recipients need to have real ownership of policy reforms, instead of old-fashioned donor conditionality. Looking ahead, a possible solution to the issues that plague conditional aid lies in self-conditionality, a system that recognizes the key role of potential aid recipients in formulating their own reform packages.

Under a new framework of self-conditionality, the donor institution in question acts like a commercial bank. It would play a much more passive role and instead allow potential borrowers to take the initiative in presenting a “self-conditionality list” that outlines a multi-year reform package. As mentioned in Ranis (2011), given that it would be impossible for a government to do too many things at once on a number of different policy fronts, realism calls for the self-conditionality list to concentrate on a few critical self- determined areas over any three- to five-year period. While uncertainties about the “right” reform package undoubtedly will still exist, a package put together by main domestic stakeholders stands a better chance of succeeding than one that is subject to either implicit or explicit donor conditionality. In addition, the institution should disburse funds on the basis of a commitment to future reform, rather than assessing the effectiveness of past reforms and disbursing aid accordingly. If help is required in formulating such a reform package, it should come from independent third parties, not from major donors, and should preferably be financed by foundations or other private parties – a separation of advice from financial support.

Additionally, instead of the grants-for-projects approach, favored by Easterly and Skarbek and Leeson, policy-based program lending or grants should be relied upon under the framework of self-conditionality. Traditionally, donors have provided aid either through the financing of specific projects (project aid), which often involved direct participation in their design and implementation, or through providing support to the recipient government’s budget (conditional budget support) while imposing conditionality on how to allocate the available resources. Conditional budget support and project aid have both their own shortcomings when the objectives of donors and recipients are not perfectly aligned. The effectiveness of general budget support depends on what the aid money is actually spent on, while project aid carries the risk of crowding out development expenditure that the government would have undertaken in the absence of foreign aid, and therefore running the risk of aid misplacement.

As mentioned in Ranis (2011), some of the more successful cases of foreign assistance, including Taiwan and South Korea in the 1960s and Costa Rica and Chile more recently, give ample evidence of the power of fast-flowing, policy- based lending, appreciated by recipients and enabling them to buy off domestic veto players. Project aid clearly has the ability to provide additional local capacity at the micro level and tends to be more politically appealing: however this does not necessarily render it an effective instrument for poverty reduction on a larger scale. Under the framework of self-conditionality, rather than having donors finance individual projects, the entire country should be viewed as “the project”, given the well-known fungibility of resources.

There should be no compulsion to lend on the part of donors, and agreement on the conditions may or may not be reached in every instance. The quantity of loans disbursed should not be used as a measure of the success or effectiveness of the aid institution, and neither should it be tied to the compensation packages of executives working in the institution.

To maintain credibility, the donor institutions will have to commit to cutting disbursements if self-conditionality terms are not met, to make it clear that the “ritual dance” will not be repeated. On the quantitative side, the institution would require sufficient funds to enable a temporary increase in aid for successful applicants over a period of three to five years, long enough to match the political and economic adjustment requirements of the proposed reforms.

A potential model for such an institutional change is a modified Millennium Challenge Corporation (MCC), an independent US foreign aid agency that aims to reduce poverty by promoting growth. The MCC makes use of 17 policy indicators to determine recipient country eligibility and negotiates compacts with these countries to fund specific projects. The MCC currently rewards countries for past performance, rather than their commitment to future policy changes, and has already made a number of exceptions to its own rules by providing strategic aid to advance US foreign policy aims, casting doubt on the claim that it is all that different from typical corruption-prone aid programs. As mentioned, however, aid allocated strategically is not necessarily aid wasted – there is still scope for achieving a “second-best” outcome if the money is utilized effectively.

Adopting such a framework would require a sea change in the current culture prevalent amongst participants in the foreign aid community. Donors must be willing to stop using aid as a short-term foreign policy tool, and recipients must accept the notion that aid represents their opportunity to reduce the inevitable adjustment pains caused by real reforms, not to take the pressure off.

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