

EVALUATION OF THE IMPACT OF FOREIGN AID ON GROWTH AND DEVELOPMENT

by

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SUMMARY

Foreign aid is publicly motivated by a moral obligation to help the poor and develop underdeveloped countries. Donors have invested more than US\$2.3 trillion in foreign aid, but despite this significant investment, 3 billion people are still living on less than \$2 a day, 840 million are hungry, 10 million children die from preventable disease, and 1 billion adults are illiterate.

This study focuses on the impact of foreign aid on economic growth and development of underdeveloped countries. It was found that many variables influence growth and development and that cross-country regression analysis is an inappropriate method to measure the effectiveness of aid. The methodology is too generalist, and treats foreign aid as a homogenous entity that works equally in all countries in all types of environment and across all times. There is an urgent need to develop a new methodology for measuring the effectiveness of foreign aid.

KEY TERMS

Foreign aid, aid effectiveness, impact, donor, cross-country regression analysis, bilateral aid, poverty, economic growth, development, aid allocations

LIST OF ABBREVIATIONS

BNA	Basic Needs Approach
DFID	Department for International Development (UK)
G19	Group of nineteen donors in Mozambique
GNP	Gross National Product
IFI	International Finance Institutions
IMF	International Monetary Fund
IRD	Integrated Rural Development
LDC	Least Developed Countries
MDGs	Millennium Development Goals
NGO	Non-governmental Organisation
NIC	Newly Industrialised Country
NORAD	Norwegian Agency for Development Cooperation
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary Least Squares
OPEC	Organization of Petroleum Exporting Countries
PRS	Poverty Reduction Strategy
SAP	Structural Adjustment Programme
SWAps	Sector-Wide Programme Aid
UNDP	United Nations Development Programme

UNICEF United Nations Children's Fund
US United States of America
USAID United States Agency for International Development

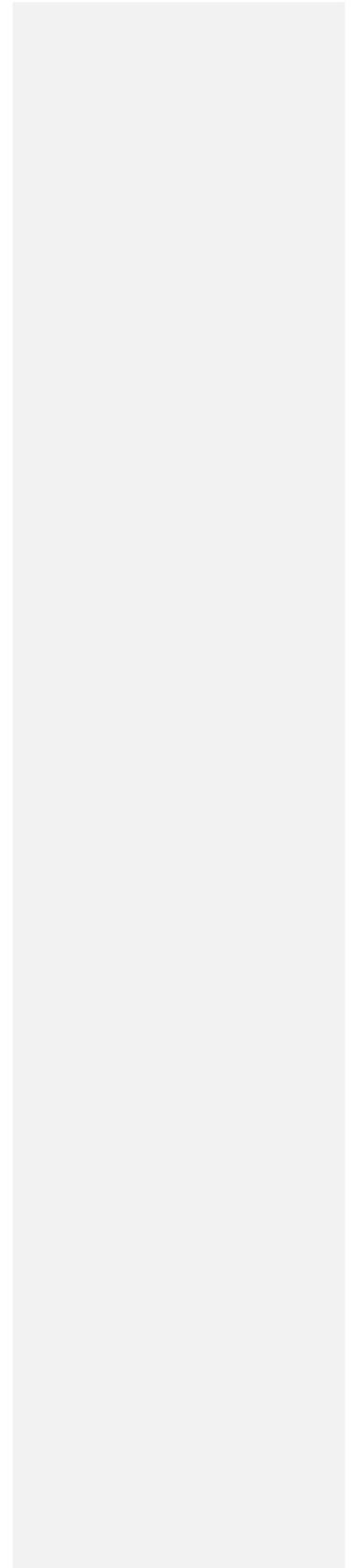


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CHAPTER 1: ORIENTATION TO THE STUDY

1.1 INTRODUCTION

This study focuses on the impact of foreign aid on economic growth and development of underdeveloped countries. It involves a literature review of the past 50 years of research on the influence of foreign aid on growth and development, and presents an evaluation of the literature on aid effectiveness. Despite a significant volume of research, we are still uncertain of the bearing that foreign aid has had on economic growth and development. Thus, the research problem of the study is the uncertainty of the impact that aid has on economic growth and development.

1.2 BACKGROUND TO THE STUDY

In the 1950s, the success of the Marshal Plan in Europe created a great deal of optimism that the provision of foreign aid to poor countries would stimulate economic growth (hereafter referred to as growth) and development in recipient countries. At its inception, foreign aid was based on modernisation theory, together with the belief that wealthy nations had a moral obligation to support growth and development in underdeveloped countries. Foreign aid was thought to be the catalyst needed to stimulate growth and development. Early growth models argued that underdeveloped countries were poor because of their low levels of savings and investment. Inadequate savings and investment meant that these countries lacked the necessary resources to invest in infrastructure, capital equipment and modern technology. Unable to invest in their own growth, underdeveloped countries stagnated, and the apparent solution to their dilemma was foreign aid, which could fill the savings and investment gaps.

Foreign aid in its broadest definition consists of the provision of resources, including goods, technical assistance, loans at concessional rates, and financial grants. Donors, who are not necessarily rich, provide aid to recipients, who are not always poor. Donors provide aid to stimulate growth, promote development, and contribute to the reduction of poverty in underdeveloped countries. Aid is provided to developing countries in a number of forms including bilateral aid (direct country-to-country aid, for example United Kingdom aid to Mozambique); multilateral aid (aid provided by donors to multilateral aid organisations, for example UN agencies, World Bank), humanitarian aid, project aid, military aid and aid channelled through non-governmental organisations (NGOs) (Riddle 2007:18).

Foreign aid is publicly motivated by a moral obligation to help the poor and develop the poorer underdeveloped countries, but clandestinely foreign aid serves to promote donors' political, economic and strategic interests. In 1949 US President Truman stated during his inaugural address, 'We must embark on a bold programme for ... the improvement and growth of underdeveloped areas. More than half the people of the world are living in conditions approaching misery' (Riddle 2007:25). Truman's 1949 address launched foreign aid, and trillions of dollars have since been spent on growth and development, but with little measurable success. In 1961, Rostow, economic advisor to US President Kennedy, stated that existing foreign aid programmes were generally unsatisfactory and that the coming decade of development would 'see a decisive turnaround in the fate of the less developed world, looking toward the ultimate day ... when foreign aid will no longer be needed' (Easterly 2006:21). Optimistically the World Bank headquarters bears the inscription 'our dream is a world free of poverty'. The Millennium Development Goals (MDGs) promise 'to eradicate poverty, promote human dignity and equality'. Bono¹ sings and Sachs² dreams about 'making poverty history'.

Yet despite substantial investment, foreign aid has not produced the expected results in terms of economic growth or poverty reduction. Botswana, South Korea, Zaire and Zambia have all received foreign aid. Botswana and South Korea have developed and prospered, yet Zaire and Zambia have spiralled down into economic oblivion and destitution. Over the past 60 years, donors have invested more than \$2.3 trillion in foreign aid. Yet despite this significant investment, 3 billion people still live on less than \$2 a day; 840 million are hungry; 10 million children die from preventable disease; and 1 billion adults are illiterate (Easterly 2006:7).

Early research (1950–1970s) on aid effectiveness focused on the relationship between foreign aid, savings and investments. Domar (1947) and Rostow (1956), who influenced the modernisation theory on which foreign aid was based, both argued that aid could be used to boost domestic savings, which in turn would stimulate economic growth (in Clemens, Radelet & Bhavnani 2004:4).³ But not everyone agreed with foreign aid's theoretical ability to promote growth. Friedman (1958) for example predicted that 'new aid programmes would not lead to economic growth' (in Hudson & Mosley 2001:1023). Early research began to reveal that indeed foreign aid might not be delivering on its promises. Rahman (1968) and Gupta (1970) both found that foreign aid had no impact on domestic savings (in McGillivray, Feeny, Hermes & Lensink 2006:1034). Griffin (1970:106)⁴ found that foreign aid caused public savings to decline. Griffin's research indicated that foreign aid actually caused a deterioration in economic growth, and that aid was being allocated to public consumption, which was reducing the levels of domestic savings. Griffin (1970:106) also observed that foreign aid was creating a decline in tax revenue, since the inflow of easy foreign aid was acting as a disincentive for government to increase tax collection efforts. Griffin argued that growth targets could be achieved only if the recipient country

was literally 'drowned in aid' (1970:108). Bauer (1972) found that aid had 'little effect on growth' (in Singh 1985:217). Weisskopf (1972) found a negative relationship between foreign aid and domestic savings (in Clemens et al 2004:5).⁵ Weisskopf's conclusions supported Griffin's (1970) and Griffin and Enos's (1970) negative conclusions (in Clemens et al 2004:5). Papanek (1973), however, who studied foreign aid in the 1950s and 1960s, appeared to overturn the negative conclusions of Griffin (1970), Griffin and Enos (1970) and Weisskopf (1972). Papanek (1973:129) concluded that aid had a 'more significant effect on growth than savings or any other form of foreign income'. The early research up to 1975 concluded, though with some ambiguity, that aid had little or no impact on growth. Researchers had also begun to consider other variables that might be influencing the impact of aid on growth and development.

The research from 1980 to 1995 generally painted a more positive picture of foreign aid. But this picture was also far from conclusive. Suppositions during this period were often fragile, supported by qualifier statements or subject to methodological and data disputes. The focus of research had also switched away from savings and investment, and increasingly focused on the influence of aid on growth. During the period 1980–1995 researchers continued to produce conflicting results with respect to the impact of aid on savings, investment and growth. For example, Singh (1985:230) and Mosley and Hudson (1995, in Hudson & Mosley 2001:1025), studying the effect of aid on savings, found that aid had a negative impact on domestic savings, whereas Dowling and Hiemenz (1982:3) found that aid had a positive effect on domestic savings. The impact of aid on investments was equally contradictory. Boone (1995:28) and Mosley and Hudson (1995) found that aid had no impact on investment (in Hudson and Mosley 2001:1025). On the other hand, Heller (1975:429), Dowling and Hiemenz (1982:11) and Levy (1988:1793) all concluded that aid had a positive impact on investment. In an aid and growth analysis, Mosley and

Shan (in Durberry, Gemmel & Greenaway 1998:3) found a negative relationship between aid and growth, but Mosley, Hudson and Horrell (1987:636) and Boone (1995:27) concluded that aid had no impact on growth. More positively, Dowling and Hiemenz (1982); Gupta and Islam (1983); Singh (1985); Levy (1987); Killick (1991); Levine and Renelt (1992); Hadjimichael, Dhaneshwar, Muhleisen, Nord and Murat-Ucer (1995:2) and Mosley and Hudson (in Hudson & Mosley 2001:1025) all concluded that aid generally did have a positive impact on growth. Consensus from the period 1980–1995 was that aid did appear to have some positive impact on growth, which contradicted the negative conclusions of the early research.⁶

Although the question ‘Does aid work?’ had remained unanswered up to this point in the debate, the research was producing some positive side effects, and sought to explain why aid appeared to be ineffective. The research was increasingly evaluating the effect of variables such as donor motives, quality of recipient governance, recipient absorptive capacity and shocks were having on the impact of foreign aid on growth and development. More importantly, the research stimulated a robust debate in academic, donor and public domains.

From the late 1990s, the research continued to be ambiguous about the impact of aid on growth. Research continued in its cyclic fashion from ‘Aid works’, ‘No it doesn’t’, to ‘Aid works, but it depends on ...’. An example of this cyclic nature of the aid effectiveness debate is demonstrated in the literature on the question of foreign aid and recipient policy. Burnside and Dollar, two renowned World Bank economists, published a working paper in 1997 that considered the recipient’s policy environment.

Burnside and Dollar (2000:847) argued that aid influenced growth, but that the impact of aid was conditional on the quality of the recipient’s macroeconomic policies. The

effectiveness of aid therefore depended on how it was used by the recipient. For example, in a country with a poor economic environment, aid might be used to fund public consumption or unproductive investments, instead of productive ones. That is, aid was wasted. If aid is invested productively, it can increase domestic production, and have a positive influence on growth. However, if aid is used for public consumption, there is little increase in productive output, and therefore aid has less impact on growth (Burnside & Dollar 2000:847). Burnside and Dollar (2000:864) recommended that donors provide aid only to countries with good policies, and that aid should be made conditional on the quality of the recipient's policies. However, the Burnside and Dollar (2000)⁷ analysis was subject to intense debate in the literature.

A number of researchers disagreed with Burnside and Dollar. For example, Guillaumont and Chauvet (2001:87) found that the impact of aid on growth was not increased by good policy. They acknowledged that good policy is important for economic growth, but that the effect of policy is not increased by aid. Lensink and White (2000:5) found that the Burnside and Dollar (2000) growth analysis was not robust, and that it was possible to vary the model specification and obtain a different result. Lensink and White (2000:5) criticised the Burnside and Dollar (2000) analysis for the narrow range of items it identified for inclusion in the analysis. Mavrotas (2002:45) concluded that both programme and project aid had a negative impact on growth. But he conceded that despite a negative overall result, policies do have an important influence on the effectiveness of aid. Hudson and Mosley (2001:1025) questioned the Burnside and Dollar methodology and found that the effect of aid on growth had not been particularly high, and that the evidence was ambiguous. Hudson and Mosley (2001:1025) found no evidence of good policies improving the effectiveness of aid. They acknowledged that aid had not been a total failure, but stated that the success of aid to a degree depends on it being able to operate in a good policy

environment. Hudson and Mosley (2001:1035) stressed that the virtue of the Burnside and Dollar work was that it focused attention on the importance of good policy and allocating aid to ensure optimal aid impact. Hudson and Mosley (2001) and Mavrotas (2002), despite finding no relationship between aid, growth and policy, still pointed out that the policy environment was important to growth. This point of view has continued to be a thread throughout the debate.

From the above sample, which is just one strand in the aid effectiveness debate, it is clear that measuring the impact of aid is a difficult task. The problem is that the literature provides no definitive and conclusive evidence that aid is having a positive impact on growth and development. The impact of foreign aid on economic growth and development is dependent not only on the volume of aid flows into the recipient country, but also on the behaviour of the donors and recipient countries. There is uncertainty about the methodology being used to measure the impact of aid on growth and development. The cyclic nature of the debate in the literature indicates that the cross-country regression analysis may not be the most appropriate methodology to measure the impact of foreign aid. In light of the above discussion, the research problem is that, despite a significant volume of research, we are still uncertain of the influence that foreign aid has had on growth and development in aid-recipient countries.

After 50 years of investment, foreign aid is still failing to deliver its primary objective, which is a world free of poverty. The question is why does foreign aid appear to be ineffective? The focus of this study is an evaluation of the impact of foreign aid on growth and development in underdeveloped countries. The study also determines how donor behaviour, aid inflows, recipient behaviour, and context dilute the effect of foreign aid on growth and development.

1.3 RESEARCH PROBLEM

Despite substantial investment, foreign aid has not produced the expected results in terms of economic growth or development. Why does foreign aid appear to be so ineffective? Since the early 1950s, researchers have tried to answer this important question. But after nearly 50 years of research there is still no definitive answer. While the research has been inconclusive about the impact of foreign aid, the literature has demonstrated that aid does not work in isolation, and that a number of important variables influence and even dilute the positive effects of aid (see discussion in section 1.5). Knowing how aid interacts with these variables is crucial, since it will help donors, recipient countries and policymakers to take better decisions and implement processes that will improve the effectiveness of foreign aid. The literature has also affected the public's impression of aid. There is increased 'aid fatigue' as the public grow tired of providing aid that apparently is so inefficient.

Cross-country regression analysis is a statistical econometric methodology that is used to measure the effectiveness of foreign aid. Conducting a cross-country regression means assembling large samples of data from a multitude of countries (sometimes up to 137 countries), all at various stages of development, and then statistically calculating whether foreign aid, on the whole, has had any impact on growth and development. This form of analysis treats all countries, aid types and time periods as homogeneous units, which they certainly are not. Furthermore, foreign aid operates in a complex environment in which donor motives in providing aid and the recipient's use of aid dilute the influence aid may have on growth and development. It is important to understand the effect that donors, aid inflows and recipients have on the impact of aid on growth and development. There must be a better way to evaluate and measure the effectiveness of foreign aid than the endless

stream of ambiguous cross-country regression analysis. Research and empirical conclusions on the influence of aid, based on cross-country regression analysis, depend on critical methodology choices. Roodman (2007:18) suggests that cross-country regressions may have reached the limits of their ability to reveal how effective aid is in affecting growth. According to Bourguignon and Leipziger (2006:6), evidence from specific programmes and country case studies may provide a better understanding of aid efficacy. But even if researchers figure out a better methodology for measuring the impact of foreign aid on growth, there is still the question as to why the impact of aid is measured against the indicators of economic growth? Foreign aid is still supplied to developing countries to serve not only the needs of these recipients, but also the donor's political, strategic and economic objectives. Donors continue to provide foreign aid to serve their own objectives, and economic growth and development in the recipient country is a secondary aim. If donors provide aid to achieve their own objectives, then one cannot measure aid effectiveness solely against the indicators of economic growth. What we can expect to see is a proliferation of donors in recipient countries. If after more than 50 years of research, we still do not have a conclusive answer to the question of whether aid is effective, then we should examine whether the methodology currently used to measure the effect of foreign aid is the most appropriate. In the light of this discussion, the research problem of this study is the uncertainty of the impact that aid has on economic growth and development.

1.4 RESEARCH OBJECTIVES

In order to address the research problem, the study's primary objective is to conduct an evaluation of the impact of foreign aid on economic growth and development in underdeveloped countries.

To achieve the primary objective of this study the following secondary objectives have been set:

- 1 To provide a theoretical framework to study the impact of foreign aid on economic growth and development
- 2 To analyse the literature on aid effectiveness
- 3 To investigate the impact of donor behaviour and aid inflows on the effectiveness of foreign aid
- 4 To investigate the impact of recipient behaviour, recipient's environment, and external factors on the efficacy of foreign aid
- 5 To evaluate the relevancy of cross-country regression analysis for measuring aid effectiveness

1.5 RESEARCH METHODOLOGY AND TECHNIQUES

Since the early 1950s a substantial body of literature has evolved that debates the effect of foreign aid on growth and development. This study is a literature review of aid effectiveness research papers, focusing principally on the measurement of the impact of aid on growth and development. The literature review examines existing knowledge, identifies key works, and determines how the various papers are related (Hart 1998:30). Through a process of reviewing and analysing the body of knowledge, this study will address the research question, and determine what variables contribute to reducing the impact of foreign aid on growth and development.

A literature review is defined as 'the selection of available documents (both published and unpublished) on the topic, which contain information, ideas, data and evidence written from a particular standpoint to fulfil certain aims or express certain views on the nature of the topic and how it is to be investigated, and the effective evaluation of these documents

in relation to the research being proposed' (Hart 1998:13, and Babbie 2011:95). A literature review is a non-empirical methodology that uses secondary data from papers that have been published in journals and academic books (Mouton 2001:179). A process of inductive reasoning will be used to gain an understanding of the debate surrounding the question of what impact foreign aid has had on growth and development. The sample was drawn from key papers in economic and development journals, academic books and the Internet. The sample was limited to approximately 200 papers, at which point saturation was reached.

The strength of a literature review is that it provides an understanding of the debates about the impact of aid on growth and development. The literature provides a historical narrative of the evolution of foreign aid, development economics and development theory since the inception of foreign aid after World War II. A literature review provides the theoretical foundation and methodologies used to measure the impact of foreign aid (Mouton 2001:180). But a literature review has certain limitations, since at best it provides only an analysis of existing scholarship. Although this study is a critical review of the literature, it will not produce any new evidence; nor will it provide any new empirical insights (Mouton 2001:180). Our literature review, however, will analyse more than 50 years of research; it will group themes and trends into typologies; and it will determine the key variables that contribute to reducing the influence of foreign aid on growth and development. The literature review will also assess the methodologies used to measure the impact of aid. There are a number of potential sources of error when conducting a literature review, including the selection of the sample; unfair treatment of the authors; poor organisation and analysis of the review; and selective interpretation of the literature to suit a particular point of view (Mouton 2001:180). This study will make every effort to minimise the effect of these potential errors.

The study uses secondary data drawn from papers published in development and economic journals and books. The review sample is restricted to approximately 200 papers, with the intention of reaching saturation on the topic. The sample included a limited number of documents downloaded from the Internet. The use of the Internet was limited to sourcing conference papers, government policy documents and research papers cited in the literature, but not published in journals or academic books. The papers used in the sample were sourced through UNISA Library's e-journal finder. Papers that were not available were requested through the library's journal request process or sought on the Internet.

The purpose of the literature study was to analyse the main conclusions, supporting evidence, and arguments presented in the literature. The reading of each paper or book began with the completion of a 'literature analysis notes form'. This form captured the bibliographic information, conclusions and notes from the reading. A special 'analysis of studies' form was also designed to capture conclusions and observations from the reading. During the reading, the arguments and the conclusions of each paper were recorded on this form for later analysis using a specially designed data management programme. The analysis of the literature was completed at the end of the reading process.

A specially designed Microsoft Access database facilitated the analysis of the hundreds of observations and conclusions extracted from the literature. The notes from the analysis of studies forms were transferred into the database. More than 1 400 conclusions were organised and categorised using database queries. The results of the queries were then further sorted and filtered until only the relevant records were retained for analysis. This data-processing methodology made it possible to reflect on the arguments and the trends

in more than 50 years of research. The database was also used to organise the papers, conclusions and arguments into specific categories. This method of analysis was instrumental in discerning the arguments from both sides of the debate and detecting the emerging trends in the literature. The analysis revealed that not only was the aid effectiveness debate ambiguous, but that a number of important variables were emerging, particularly in recent papers. These variables are discussed in more detail in chapters 4 and 5.

1.6 IMPORTANCE OF THE STUDY

Foreign aid effectiveness research and debate began in the early 1950s, and has continued to yield a series of cyclic and hotly contested conclusions. A brief review of the literature produces many contradictions and conflicting opinions, to the point that the reader is left with the feeling that no one knows whether foreign aid is effective or not. [In 2005 for example Erixon \(2005 in Riddell 2007:166\) argued that the evidence clearly demonstrated that foreign aid did not have any impact on growth and did not increase welfare and should therefore be phased out rather than increased. Conversely in the same year the popular book "The End of Poverty" by Jeffery Sachs argued that aid should be urgently doubled because there was compelling evidence of its undoubted success \(Sachs 2005:3\).](#) This situation is not helpful to development practitioners, policy makers or donors, since it provides no conclusive evidence to influence policy or decision making. [Most disputes about the impact of foreign aid are found in either the data sets that the researcher has used or in the methodology and the statistical model constructed by the researcher. Since policy makers, the general public and aid donors are influenced by published research on the measurement of foreign aid it is critically important that the measurement of foreign aid is both conclusive and robust. This study will demonstrate that the measurement of foreign aid is inherently flawed and an alternative methodology must](#)

[be considered. Furthermore](#) While research has not conclusively answered the aid effectiveness question, it has demonstrated that a number of important variables dilute the ability of foreign aid to have a positive impact on growth and development.

This study is important for three reasons. First, through an analysis of the aid effectiveness literature, the study will answer the important question 'Does foreign aid have any impact on economic growth and development?' Second, the study will demonstrate that aid does not work in isolation, and that many variables influence the impact of foreign aid on growth and development. Finally, the study will demonstrate that the use of cross-country regression analysis [the most popular form of analysis](#) may not be the most appropriate methodology for measuring the effectiveness of foreign aid.

1.7 LIMITATIONS TO AND SCOPE OF THE STUDY

The study was limited to official development assistance (ODA). The study ignores mega projects, non-concessional loans, charity, aid provided by NGOs and humanitarian aid. The body of literature on aid effectiveness is vast, so a sample of approximately 200 papers was used to evaluate the impact of foreign aid on growth and development.

Because this study was an analysis of secondary data only, it is limited by the integrity of the data used by the original researchers. Therefore, the study could not control data collection or constraints in the original data analysis (Mouton 2001:165).

This study was not an attempt to analyse the econometrics formulae used in the sample papers, as econometrics belongs to the field of economics, and not development studies. This study relied on the conclusions drawn by the researchers (all of whom are economists) and who all presented convincing arguments that their research, data,

models, equations and analyses were correct and providing reasons for others before them having failed.⁸ The study made a thorough analysis of the sample, and draws its own conclusions as to the impact of foreign aid on growth and development.

1.8 CLARIFICATION OF TERMS

The following concepts are defined to ensure clarity in this study. Aid in the context of this study is limited to and defined as 'assistance provided to government through bilateral agreements for direct budget support, and multilateral agreements for grants and concessionary loans' (DFID 2008:10). The study ignored charity and humanitarian aid, as their contributions to development are small in comparison with bilateral and multilateral aid. Bolton (2007:82–146) provides a useful typology of aid:

Humanitarian aid: Aid to developing countries during humanitarian emergencies, for example floods and tsunamis (this constitutes 5 per cent of all aid globally).

Charity aid: Aid to developing countries channelled through registered charities, for example Save the Children, Oxfam, CARE. (This constitutes \$3–5 billion per year.)

Bilateral aid: Assistance provided directly by northern governments through their own aid agencies, for example DFID, USAID, and NORAD. (This accounts for 70 per cent of aid money funded by taxes.)

Multilateral aid: Aid delivered through international institutions, for example World Bank, European Commission, UN and African Development Bank. (About 30 per cent of aid to Africa is channelled through the international institutions.)

Development: An elusive term to define, since the context of development is continually evolving. Bown (in Regan 2010:42) provides a useful definition of development, which frames development in the context of this study. Bown defines development as 'an ever moving target. It can never be finally achieved and the process should never be arrested.'

It will best be moved forward if all citizens contribute actively to decisions about it and there is a constant opportunity for individuals and groups to participate in all aspects of it.'

Foreign aid and aid: In the context of this study (and the aid effectiveness literature) the terms 'foreign aid' and 'aid' are used interchangeably, and both terms refer to ODA. The literature consulted in this study is limited to measuring the impact of ODA. No other forms of aid or humanitarian relief are considered.

Direct budget support: General budget support in the form of money given by a donor to a developing country. The money supplements the state budget, as it is usually given through a joint agreement between donor and recipient (DFID 2008:15).

Sector budget support: Common funds (large and small) provided by donors to sectors of health education, HIV, agriculture, etc (DFID 2008:15).

Growth and economic growth: These terms are used interchangeably in this study and in the aid effectiveness literature. They refer to economic growth measured in terms of gross national product (GNP).

Cross-country regression analysis: Cross-country regression analysis is a statistical methodology for measuring the impact of aid on growth and development. Cross-country regression means assembling large samples of data from a multitude of countries at various stages of development and then statistically calculating whether aid overall has had an impact on growth and development. This form of analysis treats all countries, aid types and time periods as homogeneous units (Rajan & Subramanian 2008:647).

Panel data: Observations on multiple phenomena observed over multiple periods for the same unit of analysis. Time series and cross-sectional data are special types of panel data that are in one-dimension only (Torres-Reyn (2011:3).

1.9 CHAPTER LAYOUT

This study consists of six chapters. Chapter 1 introduces the study and describes the research problem, the objectives of the study, and the importance of this particular study. Chapter 2 provides a theoretical framework for the study on the impact of foreign aid on economic growth and development. This framework traces the evolution of development and economic theory from the late 1940s to the present. It demonstrates the links between economic theory and foreign aid, and shows how foreign aid has followed and underpinned many of the key principles in development and economic theory.

Chapter 3 is an analysis of the literature on aid effectiveness from the early 1950s to the present. The analysis attempts to establish the impact of foreign aid on growth and development and demonstrates the debates, contradictions and challenges faced when trying to measure it. Chapter 4 demonstrates how donor motives, the actions of donors themselves, and aid inflows contribute to the reduction of the impact of foreign aid on growth and development. Chapter 5 reveals how the recipient environment, actions of recipient governments, and external variables such as disasters and climate dilute the effect of foreign aid. Chapter 6 draws the discussion to a close. It summarises the main conclusions and shows the roles that donors, recipients, aid inflows and the external environment play in reducing the impact of foreign aid. Chapter 6 also summarises the methodological challenges, and recommends an alternative methodology for measuring the impact of foreign aid on growth and development.

NOTES

¹ Bono is the lead singer of the popular rock band U2. Bono is also actively engaged in advocacy. For example, he supported the Jubilee 2000 campaign for the cancellation of Third World debt.

² Jeffrey Sachs is director of the Earth Institute and was special advisor to United Nations Secretary-General Kofi Annan. Sachs (2005) is author of the popular book *The end of poverty*.

³ Domar was one of the founders of the Domar-Harrod growth model and Rostow was a key influence in modernisation theory. Both researchers argued that aid could be used to promote economic growth, but it should be remembered that their arguments came at the birth of aid and there were no data or studies to contradict their assumptions.

⁴ Griffin and Enos (1970) drew the same conclusion (in McGillivray et al 2006:1034).

⁵ Weisskopf's (1972) conclusion that aid had no impact on savings implied that aid did not influence growth, according to the gap models, since aid was intended to fill the savings gap and therefore stimulate growth. In other words, if aid did not fill the savings gap, then aid would not contribute to growth. So for the aid/growth relationship we can conclude that Weisskopf (1972) found that aid had no impact on growth

⁶ This conclusion is supported by other researchers. See for example Hansen and Tarp (2000:114).

⁷ The Burnside and Dollar paper was developed over a number of years. It was first circulated in 1997 and 1998 as a World Bank Policy Research Working Paper. The paper was also cited in the World Bank 1998 Report titled *Assessing Aid*. In 2000 the paper was published in the influential *American Economic Review*. From this point onwards I refer to the paper as Burnside and Dollar (2000) for simplicity. In essence, the Burnside and Dollar (1997), (1998) and (2000) papers are all the same.

⁸ The following papers present an excellent discussion on the econometric models and formulas used in measuring aid effectiveness: White (1992), Hansen and Tarp (2000), Clemens et al (2004), McGillivray et al (2006), Rajan and Subramanian (2008), Dalgaard and Hansen (2009) Dalgaard and Hansen (2010). These papers all present detailed econometric explanations of the various underlying economic models, data sets, regression analysis and equations used in measuring aid effectiveness.

CHAPTER 2: THEORETICAL FRAMEWORK

2.1 INTRODUCTION

In the 1950s, the success of the Marshall Plan in Europe created a great deal of optimism about the ability of foreign aid to stimulate growth in developing countries. At its inception, foreign aid was based on modernisation theory, together with the belief that the wealthy nations had a moral obligation to support growth and development in underdeveloped countries. Foreign aid was thought to be the catalyst needed to stimulate growth and development in underdeveloped countries. Early growth models argued that underdeveloped countries were poor because of their low levels of savings and investment, and therefore they lacked the necessary resources to invest in infrastructure, capital equipment and modern technology. Foreign aid was designed to fill the savings and investment gaps, which in turn would allow developing countries to save, invest, grow and develop.

This chapter briefly traces the evolution of development economic theory, setting the theoretical framework for the study. Particular attention is paid to trends that influenced the allocation of foreign aid to developing countries. The narrative explains the role of foreign aid from the 1950s through to the early 2000s (divided into decades), drawing out the main concepts and how they influenced the allocation of foreign aid.

2.2 DEVELOPMENT, ECONOMIC THEORY AND FOREIGN AID

Modernisation theory was the theoretical base of early development and the foundation of foreign aid. Modernisation theory can be traced back to classical theorists such as Comte

(1798–1857), who focused on science and rationality; Spencer (1820–1903), who focused on societal evolution and specialisation; Durkheim (1858–1917), who developed the concept of the division of labour; Tönnies (1855–1936), who theorised that change was a transition from a traditional society to a modern society; and Weber (1864–1920) who explained the emergence of the modern capitalist system (Stewart 2005:22–29). Modernisation theory argued that countries that wished to become modern must emulate the development model of Western Europe and the United States. Modernisation theory conceptualised development as a linear process, in which society transitions from a backward traditional culture into an advanced modern, industrial and technological social order. Foreign aid would be the tool that would transform underdeveloped countries into developed ones (Stewart 2005:65).

The discussion that follows briefly traces the implementation of modernisation theory, and demonstrates how foreign aid closely followed the evolution of this concept. The discussion examines the role of the Harrod-Domar and two-gap growth models of the 1950s and 1960s, the influence of dependency theory, and the failure of macro economic development, which led to the radical switch in the 1970s from big-push modernisation to pro-poor rural development in the form of integrated rural development (IRD) and the basic needs approach (BNA). By the 1980s, foreign aid was still not producing the anticipated results. Poverty was increasing; growth was stagnant; and the economic crisis of the early 1980s contributed to an increase of Third World debt and the near failure of the global economy. The chapter concludes with a brief review of neoliberalism, structural adjustment, the Washington Consensus and the Post Washington Consensus.

2.2.1 MODERNISATION THEORY

In the 1950s economic growth was the primary policy driver in developing countries. Modernisation theory reinforced the belief that modernisation and associated growth would reduce dualism and its socio-economic inequalities. Modernisation theory provided development with concepts such as Rosenstein-Rodan's (1943) 'big push'; Rostow's (1956) 'take-off into sustained growth'; Nurkse's (1953) 'balanced growth' and Leibenstein's (1957) 'critical minimum effort thesis' (in Escobar 1995:74). The big-push concept emphasised the economy of scale, while the critical minimum effort thesis argued that increased investment would trigger a cumulative growth process. The balanced growth concept stated that an increase in market demand would result in a mutually reinforcing and complementary expansion of productive activities and a rapidly expanding economy (Regan 2010:31, Thorbecke 2000:20 and Escobar 1995:74). Within modernisation theory, savings and investment were considered the principal drivers of growth. Modernisation theory argued that the economy, through industrialisation, could take off, and that the spoils of growth would trickle down to the greater population. Industrialisation would lead to economic growth, and therefore development would follow. The emphasis in the 1950s was on domestic savings, productive investments and a growing economy (Hewitt 2000:293). The only needs of developing countries were capital and knowledge, which aid would provide to support industrialisation.

Modernisation theory states that a society and its economy can achieve sustainable economic growth within 20 to 30 years. Rostow (1956:26) defines economic take-off as the period in which the rate of investment increases, so that per capita output rises and the associated increase in output brings about significant changes in production and technology. Increased income generated by growth leads to increased investment, which in turn stimulates greater per capita output, until the growth becomes self-sustaining. In

Rostow's theory, the sequence of economic growth passes through three distinct phases. Phase 1 is when the 'preconditions to take-off' are established by society. Slow deep-rooted changes in the social order are a precondition to take-off. In the second, take-off phase, dramatic changes in production and technology occur. In the final phase, sustained growth, society enjoys a long period of constant economic growth (Rostow 1956:27). For take-off to be successful, it requires significant changes in the organisation, values and structure of society. A developing country must find ways of changing, organising and exploiting its natural, physical and human resources, coupled with a vibrant and growing industrial sector (Rostow 1956:26–32). Foreign aid was founded on the principles of modernisation theory, according to which, poor, underdeveloped countries simply needed an injection of capital (aid) to stimulate economic growth. Foreign aid was given to developing countries to fill their savings and investment gaps, and therefore was supposed to act as a catalyst for growth. As the developing country's economy expanded and per capita income rose, modernisation theory assumed that the benefits of modernisation would trickle down to the rest of society, and in this way, all people would benefit from the modernisation process. Foreign aid in the 1950s was based on the Harrod-Domar growth model (discussed in section 2.2.2), which focused on investment as the key driver of growth.

2.2.2 DEVELOPMENT AND ECONOMIC THEORY IN THE 1950s

The early growth models were based on investment as the key driver of economic growth. The Harrod-Domar growth model assumes that underdeveloped countries have excess labour and that growth is constrained only by low productivity caused by the inadequate supply of capital. Growth is therefore determined by the availability and productivity of investment capital. A country uses its domestic savings to fund productive investment. Domestic savings¹ therefore determine how much capital is available for productive

investment (Morrissey 2001:39). The lack of domestic savings was seen as a significant limitation to economic growth in underdeveloped countries. Countries characterised by a small industrial base, low productivity, low per capita income and inadequate tax base tended to have low domestic savings (Moreira 2003:2). In an underdeveloped country, domestic savings are low because the majority of the population are too poor to save. The state is also poor, because production is too low to generate adequate tax income for government savings and investment. If the government wants to increase the growth rate, it must first increase its levels of domestic savings. Higher domestic savings allow productive investments in energy, roads and other infrastructure, which in turn increase productivity and stimulate growth (Morrissey 2001:40).

In the 1950s, development strategies were based on the principles of modernisation theory, concentrated on industrialisation as the engine of growth. The industrial sector was the focus of growth, while the agricultural sector was largely ignored. The logic of modernisation theory was that as the industrial sector grew, it would create increased demand for food and raw materials, and therefore create employment opportunities for the rural population. As industrial demand grew, there would be a spin-off effect for the agricultural sector, which would in turn provide industry with the required labour and raw materials. Investments were therefore directed towards industry, but at the expense of agriculture. In reality, the capital resources needed for industrialisation were extracted from the agricultural sector (Escobar 1995:75 and Thorbecke 2000:22). Growth and development were assessed by increased productivity (measured as GNP). Import substitution was a key industrialisation strategy in the 1950s.

Import substitution, particularly consumer goods and durables, was seen as the key to developing local industry. Promoting import substitution meant that developing countries

introduced protectionist policies, including high protective tariffs, protective barriers in the form of import quotas or bans, exchange rate control, and subsidies on local products. This inward focus, however, burdened developing countries with a highly inefficient industrial sector. The inward concentration and associated inefficiency eventually contributed to the long-term negative balance-of-payments problems in many developing countries (see section 2.3.2). Industrialisation policy also inadvertently created an urban bias and exacerbated rural poverty (Thorbecke 2000:22).

In the 1950s the emphasis on industry and infrastructure resulted in development and aid policies that were biased against the rural areas, subsequently increasing rural poverty and underdevelopment. Food prices were kept artificially low, benefiting urban workers, but at the expense of the rural people, whose main income depended on agricultural production. Readily available food aid helped developing countries maintain these artificially low food prices. Industry extracted resources from agriculture, creating biased urban growth. Public resources were increasingly channelled into the urban sector. There was no encouragement of rural institutions and no development of rural off-farm activities (Hewitt 2000:293). Foreign aid, based on modernisation theory, provided the capital to fund industrialisation, but at the same time began to create unequal growth and a distinct urban/rural bias.

2.2.3 THE ROLE OF FOREIGN AID IN THE 1950s

The role of foreign aid in the 1950s was to provide the capital to enable developing countries to achieve the high savings and investments necessary to stimulate growth and development. The Harrod-Domar growth model predicted that aid would contribute to growth by increasing the levels of capital and therefore augmenting domestic savings and

investment. Foreign aid was designed to fill the savings gap and therefore provide recipients with the necessary capital for productive investment.

The Harrod-Domar model made it easy for donors to calculate the amount of aid needed to reach a targeted growth rate. Donors provided recipient governments with aid in order to fill the savings and investment gaps. Donors assumed that recipients would use aid as intended, and that productive investment would result in sustained growth and development. The early foreign aid model was simplistic, and built on the assumption that recipients would use the money wisely. Papanek (1972) referred to the simplistic approach of foreign aid towards growth as 'curiously naïve' (in Hansen & Tarp 2000:105). However, the emphasis on industrialisation and high growth targets resulted in the neglect of agriculture and the rural poor, thus creating increased poverty, low rates of growth and economic dualism in many developing countries (Stewart 2005:46; Thorbecke 2000:23). Foreign aid, intended to provide the stimulus for economic growth, led instead to increasing debt, underdevelopment, inequality and greater poverty.

2.2.4 DEVELOPMENT AND ECONOMIC THEORY IN THE 1960s

Development and economic theory in the 1960s was dominated by a more complex economic dualism. In the 1950s development and economic theory recognised the existence of the rural sector as a supplier of cheap labour and agricultural products, but ignored the wider reciprocal roles of industry and agriculture in the economy. In the 1950s the dual economy model (for example Lewis 1954, in Thorbecke 2000:23) continued to assign rural agriculture a passive role in the economy. It was assumed that the agricultural sector had the capacity to supply unlimited labour and agricultural surpluses for the industrial sector. This dual economic model assumed that rural agriculture would release unlimited cheap labour into the industrial sector without adversely affecting agricultural

production (Escobar 1995:79). However, by the mid 1960s the interdependence between industry and rural agriculture had become more widely recognised and the dual economy models became more complex (Thorbecke 2000:24). By the mid 1960s agriculture was recognised as an active partner in industrialisation. During the early stages of growth there needed to be a flow of resources from the industrial sector to the agriculture sector. This urban-rural flow of resources was critical to increase agricultural output, which in turn would feed the industrial sector (Thorbecke 2000:25). Growth models began to recognise the importance of rural growth and development.

Growth models began to evolve taking into consideration the concepts of balanced and unbalanced growth in the economy (Escobar 1995:78; Thorbecke 2000:25). These models include the semi-input-output method, the general equilibrium model² and the two-gap model³ of Chernery and Strout (1966). The Chernery and Stout (1966) two-gap model was an evolution of the Harrod-Domar model. Chernery and Strout (1966) introduced a second gap (the foreign exchange gap)⁴ to the savings gap model of the Harrod-Domar model. In addition to a savings gap, Chernery and Strout (1966) argued that there was a second gap, namely the foreign exchange gap (in Morrissey 2001:39). Low-income countries did not have sufficient export earnings (in terms of foreign exchange) to invest in the importation of capital goods. The two-gap model stated that either of the two gaps would adversely affect growth. A country earns foreign currency by exporting raw materials, commodities, industrial products and services. Low-income developing countries, however, typically depend on only one or two primary commodities to earn their foreign currency. Primary commodities generate low income and are subject to unpredictable global markets. Dependency on one or two volatile export products means that a country's export earnings and foreign exchange are unpredictable (Hansen & Tarp 2000:106). For example, Mozambique's export earnings from aluminium were 61 per cent of GNP in

2008. By January 2009 the price of aluminium had collapsed from a high of \$3 067 per ton (June 2008) to a dismal \$1 465 per ton. The collapsing commodity price saddled Mozambique with an escalating trade deficit and a serious balance-of-payments problem (Condon 2009:13). By May 2009, Mozambique was requesting a \$160 million IMF bridging loan to fund the deficit (O País 2009). But countries are not only exporters; they are also importers for example of fuel, oil, pharmaceuticals, food, and consumer goods. They import products and services that must be paid for with hard-earned foreign currency. A growing industry requires expensive capital equipment, imported technology, machines and spare parts, which are imported and therefore paid in foreign currency. In low-income countries the cost of imports is generally higher than export earnings. The net result is a trade deficit. When a country does not earn enough foreign currency from its exports to pay for its imports, there is a foreign exchange gap. This foreign currency gap is the second gap identified by Chernery and Strout. The two-gap model influenced aid allocations in the 1960s, 1970s and still affects current World Bank and IMF policy (Easterly 2006: 322; Stiglitz 2002: 216).

In the 1960s growth was still the main development and foreign aid objective, but with a sharper focus on the relationship between growth and balance of payments. Towards the end of the 1960s it increasingly became evident that unemployment was a significant hindrance to growth and development. Development policy and strategy focused on, first, the neoclassical policy of 'fine-tuning' the economy and 'getting the prices right'. Fine-tuning the economy meant removing market imperfections, getting the exchange rate right, having appropriate economic policies, and developing an appropriate pricing system including commodity, tax and subsidy rates. Second, policies increasingly focused on inter-sectoral linkages, that is, the balanced allocation of investment and public spending in all the sectors of the economy (Thorbecke 2000:27). By the late 1960s there was

greater emphasis and investment in the agricultural sector and a decline in the discriminatory price policies of the 1950s.

2.2.5 THE ROLE OF FOREIGN AID IN THE 1960s

The two-gap model was the theoretical link between aid and growth. It was based on two principles: first, that economic growth is constrained by insufficient foreign currency and, second, by insufficient domestic savings for productive investment (McGillivray et al 2006:1032). Gap models assumed that foreign aid would boost domestic savings and fill the foreign exchange gaps. In other words, foreign capital inflows (including aid) could fill both of these gaps (Hansen & Tarp 2000:106). In reality, foreign aid was not successful in filling either of the gaps, and subsequently did not live up to expectations in terms of stimulating growth or development.

A number of factors plagued the ability of aid to promote growth and development. In retrospect, the faith in aid's capacity to fill the savings gap or the foreign exchange gap appears to have been misplaced. Aid was provided to developing countries with the intention of filling the savings and foreign currency gaps. However, with time, the provision of foreign aid resulted in a widening of these gaps (Easterly 1999:434). Foreign aid was provided to developing countries as concessionary loans, and these loans eventually accumulated a debt-servicing burden that began to widen the gaps. Developing countries therefore began to progressively ratchet up large balance-of-payment deficits, thus needing more foreign aid to bridge the widening gaps instead of reducing them. But foreign aid was not the only problem.

As savings and foreign exchange gaps increased, growth slowed down, creating more problems for growth and development. Industrialisation and import substitution were

supposed to generate growth and income to service debt repayments, while simultaneously growing the economy. However, the majority of developing countries began to experience a decline in growth. By the late 1960s, and increasingly into the 1970s, the progressively more binding foreign exchange constraint resulted in a radical appraisal of the policies of import substitution, which gradually began to be replaced by rationalisation policies (Thorbecke 2000:27).

Providing aid alone was not enough to ensure economic growth and development. The growth models, as discussed in section 2.2.2 and section 2.2.4, predicted that aid would fill the savings, investment and foreign exchange gaps. It was also assumed that 100 per cent of foreign aid would be used for productive investment (for example developing infrastructure and roads) and that aid would not be spent on funding public consumption (for example medicine, salaries, and school books).⁵ If aid was used for investment, and the investment was productive, then the early models predicted that aid would contribute to growth (Hansen & Tarp 2000:105). But the reality in many developing countries was different. Developing countries did not use all aid for productive investment. A significant portion was used to fund public consumption, which the growth models considered 'wasteful' in terms of growth (Gomanee, Girma and Morrissey 2005:300). If a recipient country used foreign aid to fund public consumption, then the positive impact of aid on the economy would be diluted (see discussion in section 2.2.4).⁶

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Inadequate foreign exchange income and low domestic savings were limiting factors on growth. Development theory and foreign aid policy in the 1950s and 1960s took two main directions. First, foreign aid, as noted in sections 2.2.3 and 2.2.5, was used to fill savings and foreign exchange gaps. Donors provided aid in the form of programme lending designed to fill the gaps identified by the gap models. Second, by the late 1960s donors

were switching to sector-specific programmes and sector aid. Sector aid recognised the importance of investing in definite sectors of the economy and developing human capital. As the importance of sector development, particularly in agriculture, became clearer, aid policy shifted to promote increased investment in human capital through the provision of technical assistance and the funding of projects in specific sectors (Ruttan 1996, in Thorbecke 2000:28).

2.2.6 DEVELOPMENT AND ECONOMIC THEORY IN THE 1970s

By the early 1970s it was evident that neither macro programmes nor sectoral aid programmes were delivering the expected returns in terms of growth or development. While some developing countries were experiencing growth by the early 1970s, not all countries were taking off and the supposed trickle-down effect was not happening. In fact, poverty and inequality were increasing (Hewitt 2000:294; Thorbecke 2000:28). According to Hewitt (2000:294), developing countries were plagued more and more with problems of inequality, unemployment, underemployment, increasing levels of absolute poverty, accelerating rural-urban migration, increasing balance-of-payment problems, declining terms of trade, and mounting foreign debt. Because of the poor performance of foreign aid in the 1950s and 1960s, attention began to turn towards poverty reduction, increasing productive employment and rural development (Hewitt 2000:294).

On the economic front, it was becoming apparent that GNP was no longer the universal instrument for measuring development. There was sharp criticism of the big push, take-off and trickle-down concepts and accompanying processes. In many circles, people began to question the idea that rapid economic growth and increased GNP would reduce poverty and accelerate growth. The economies of many developing countries were not producing the expected results for a number of reasons. First, there was the repatriation of profits

back to the developed countries, which reduced savings and investment potential. Second, there were inadequate technical, technological and economic linkages with the other sectors of the economy. Third, agriculture had been seriously neglected because of urban-biased policies, huge flows of foreign food aid disrupting local markets, deflated food prices, and removed incentives for agricultural production and investment (Hewitt 2000:295).

In economic circles it became apparent that developing countries were unlikely to emulate the growth path of the developed countries. Dependency theory, which originated in Latin America, was the developing countries' reaction to modernisation, and the inequalities associated with modernisation and the emerging global systems of trade, aid and governance. Dependency theory examined the phenomenon of continued and widening poverty in developing countries. Dependency theory argued that the poverty in underdeveloped countries was created by the unequal terms of trade and the inequalities that existed in the global trade system. Dependency theory also argued that the powerful developed countries at the core of the global economy extracted the wealth and resources from developing countries that were on the periphery of the global economy. Developing countries were supporting the economic growth of the wealthier, developed countries, while they themselves slid deeper into debt and poverty (Stewart 2005:51). Dependency theory essentially had four main arguments to explain the poor growth in developing countries. First, the obstacles to growth in developing countries were not lack of capital or of entrepreneurial skills, but unequal terms of trade within an unfair global economy. Second, in the global economy, developed countries (the core) were extracting resources from developing countries (the periphery), which resulted in underdevelopment. Third, the causes of underdevelopment in poor countries were their links with the developed countries principally through foreign aid and debt. Fourth, it was virtually impossible for

developing countries to break links with the global economy and they were therefore trapped in an unequal global economic system (Hettne, in Stewart 2005:71). Dependency theory demanded a complete redistribution of assets to the state and the abolition of most forms of private property. This development model was based on self-reliance and the adoption of indigenous knowledge, organisations and technology (Thomas 2000:46). Dependency theory did contribute to the questioning of the development models for growth. Increasingly it became accepted that development was a process that needed to include both economic growth and poverty reduction objectives. The emphasis began to swing away from macro economics, industrialisation and import substitution towards sector-based projects of rural development and poverty alleviation.

It became increasingly accepted in the 1970s that although growth was necessary, it might not be a sufficient condition for social and economic development. The fundamental issue was to improve the living standards of all segments of society, and create sustained growth. In the early 1970s the objectives of development began to broaden beyond the rigid macro economic (capital investment) focus and to incorporate a growing number of development objectives, including the creation of employment, the allocation of foreign aid to technical assistance and rural development in the form of IRD and BNA projects (De Beer, du Plessis, Liebenberg & Moloï 2001:96; Thorbecke 2000:31).

The 1970s was the era of new approaches to development, the most important being 'integrated rural development' and the 'basic needs approach' (Thorbecke 2000:29). Integrated rural development (IRD) was a strategy that attempted to channel aid directly to the poor. IRD was a move from capital-intensive macro development to project-oriented rural development. This was the birth of the 'project era' in development and took the form of rural-oriented service and small-scale income-generating projects. IRD was an attempt

to increase agricultural productivity, employment, income and entrepreneurial opportunities of the rural poor (De Beer et al 2001:100). IRD projects were integrated in the sense that they tried to encompass a spectrum of interventions, including access to basic services (for example education, health, family planning, and rural economic development) through capacity building, micro-credit, and small-scale rural industrialisation (Rondinelli 1993:65). IRD focused on using local knowledge, appropriate technology, improved inputs and market access, and IRD projects tried to focus aid on the rural poor. IRD emphasised the development of local institutional capacity by enhancing district planning and management competence. The intention was to increase the ability of local institutions to deliver services and infrastructure, and to support rural economic development (Rondinelli 1993:65; De Beer et al 2001:100).

The basic needs approach (BNA) to development focused on improving the living conditions and standards of the poor through a package of essential goods and services. The basic needs approach was based on these criteria. First, a family had certain minimum requirements for private consumption, including adequate food, shelter and clothing. Second, essential services (for example safe water, sanitation, education and health services) had to be provided (Thorbecke 2000:31). BNA projects had a strong emphasis on local resource mobilisation and a self-help approach to development. BNA also focused on extending the non-tangible aspects of development, including stress on promoting principles such as empowerment and participation (Rondinelli 1993:68). Despite the focus on rural development, rural-urban migration remained a challenge to development in the 1970s.

Rural-urban migration was another focus of development strategy in the 1970s. Research indicated that rural-urban migration was linked not only to economic motives, where rural

people migrated in search of employment and better wages, but also to social reasons, including lack of education and health services, high levels of infant mortality, fertility, and poor nutrition in rural areas (De Beer et al 2001:71). The development pendulum began to swing away from large transfers of foreign aid to recipient budgets (as in the 1950s and 1960s) towards project-specific aid, concentrating on certain target groups and objectives (in the 1970s).

2.2.7 THE ROLE OF FOREIGN AID IN THE 1970s

In the 1970s, development began to shift its focus from the single growth objective – namely capital accumulation and growth – towards a more multi-objective strategy, including sector-based aid in the form of multiple projects to reduce poverty. The new aid objectives required new forms of intervention and sector lending was developed (Brown, in Thorbecke 2000:32). The new aid approach focused on lending and technical assistance to certain sectors of the economy (for example agriculture, education and health).

In that period, donors, particularly USAID and World Bank, shifted radically from large-scale budget support and infrastructure development to smaller-scale poverty-reduction projects in agriculture, rural development and social services. There was greater emphasis on targeting the poor with direct interventions, such as nutrition, mass inoculation campaigns, adult literacy programmes and micro credit for rural farmers. The participation and involvement of the poor were emphasised as preconditions of sustainability. There was also a significant increase in technical assistance projects (Brown, in Thorbecke 2000:32). Foreign aid was provided to developing countries as a 'project package', consisting of integrated rural development programmes, basic needs projects, capital and technical assistance. The shift in aid allocation was evident from the share of poverty-

reduction lending, which was 5 per cent of total lending between 1968 and 1970, but rose to 30 per cent in 1981–1983 (Thorbecke 2000:33).

By the late 1970s, development theory had switched from the two-gap models of macro economic growth to the more focused poverty-reduction theory, including concepts such as IRD and BNA. Similarly, foreign aid changed from large-scale capital transfers to recipient governments (infrastructure, industrialisation and direct budget support) to funding a multitude of smaller, more specific rural development and poverty-reduction projects. Project- and sector-based aid became the more common model of foreign aid in the 1970s. The aim of aid had switched from growth to poverty reduction in an attempt to stem the growing trend in inequality and increasing poverty in underdeveloped countries. But the large flows of aid to developing countries, mostly in the form of concessionary loans, coupled with the failure of foreign aid to stimulate economic growth and development, resulted in increasingly large debts in many developing countries. The impending debt crisis caused development theory and foreign aid strategy to change again in the 1980s.

2.3 AID, DEBT AND THE COLD WAR

Development and aid in the period from 1950 to 1980 resulted in a debt crisis that threatened the collapse of the global economy. To conceptualise foreign aid in the 1980s, it is necessary to deviate slightly from the historical narrative of development theory and reflect on the events from the early 1950s, 1960s and 1970s that led to the debt crisis in many developing countries in the 1980s. Two key factors contributed to underdevelopment and the subsequent debt crisis. First, there was the use of aid as a strategic weapon in the Cold War, and second, the progressive accumulation of debt in developing countries. The

resultant underdevelopment and debt crises that crippled developing countries, and almost caused the collapse of the international financial markets, dramatically changed the concepts and provision of foreign aid.

2.3.1 THE COLD WAR AND AID

The Cold War was fought on the soil of many developing countries in numerous proxy wars. The term refers to a state of political and ideological tension between the capitalist West and the communist East. The Cold War did not involve direct military action between East and West, but was pursued through propaganda, economic and political action, and proxy wars waged between allied countries in the Third World or through internal civil war waged between surrogate parties, allied to the East and West, within a developing country (Stewart 2005:93). Cold War opponents provided military and economic aid to the allied countries or parties involved in the conflict. In many developing countries, the waging of proxy wars, underpinned by economic and military aid, resulted in the support of tyrants, and racked up enormous debt on both sides of the conflict. Proxy wars, political action and economic sanctions hindered development, increased poverty and led to a sharp decline in development (Regan 2010:82). Mozambique for example was allied with the communist bloc, and was subject to economic sanction and political action, principally by the US. Mozambique's economy crashed in the mid 1980s, and the country was highly indebted, owing to the cost of the proxy war fought on its soil (Hanlon 1991:21). Development became a foreign policy strategy, and foreign aid was the tool used for advancing East or West doctrines. It is no coincidence that in the past 40 years 150 wars were fought in developing countries. Many of these wars were fought with the direct participation of the Cold War superpowers (Escobar 1995:34). The global system generated conflict, instability and underdevelopment in the Third World, which was still the centre of global confrontation, despite the demise of communism (Willett 2007:1182).

2.3.2 DEBT AND AID

To understand the debt crisis that emerged in the early 1980s, it is necessary to review the global economy from the end of World War II to the end of the 1970s. At the Bretton Woods Conference in 1944 the world economists agreed to tie the US dollar to gold, and then the rest of the world's currencies to the US dollar. If the gold reserves at Fort Knox⁷ became depleted, this acted as a trigger to curtail spending in the US. Gold reserves provided a fourfold deficit control mechanism. That is, lending was reduced, demand for credit fell, which reduced the volume of imports, which finally lowered the budget deficit. The process worked well until 1971 when US President Nixon⁸ suddenly began to run out of money to pay for the Vietnam War and his anti-poverty campaigns. Nixon broke the link of the US dollar to gold, and authorised the printing of more American dollars. Nixon also introduced US Treasury bills to fund the growing deficit (Linden 2007:183). Cash reserves in the central banks around the world increased sevenfold in the 1970s, as the US pumped out US dollar bills, thus exporting US liquidity abroad. In recipient countries in which the US was buying products – for example oil – cash surpluses began to accumulate in the bank. The knock-on effect of central bank surpluses was cheap credit (Linden 2007:184).

In the early 1970s, OPEC (Organisation of Petroleum Exporting Countries) added another dimension to the global cash surpluses. In that period, OPEC quadrupled the price of crude oil, consequently escalating the problem of excess liquidity in central banks. European and American banks were flooded with liquid assets (petro dollars) and had to recycle these assets in a hurry. They reacted to the excess liquidity by offering credit at low interest rates, close to 0 per cent, to developing countries. Governments in developing countries could not resist the temptation to borrow, and were soon borrowing on the commercial markets, often for unproductive prestige projects. Developing countries were encouraged to invest in expensive industrial equipment, unproductive infrastructure,

airports, roads, monuments and many other white elephant projects, which added to their growing debt (Linden 2007:184).

In the early 1980s, the US economy began to slow down and the US Treasury increased its internal interest rates. Interest rates around the world soon followed. In the late 1970s, commodity prices fell, further reducing foreign currency earnings. Reduced foreign earnings, coupled with rising import bills, higher interest rates, declining foreign capital earnings, and huge debt servicing burdens from high interest rates meant that many developing countries were faced with serious debt crises (Linden 2007:184).

In the 1980s President Regan (US) and Prime Minister Thatcher (Britain) introduced neoliberalism,⁹ which was characterised by drastic cuts in government services, health, education and wages. Neoliberalism eliminated trade barriers, subsidies and protectionism, and introduced the concepts of free markets, floating exchange rates, privatisation, trade liberation, fiscal austerity, and the reduced role of the state (Linden 2007:186). Debt allowed the World Bank and the IMF to exercise control over the debtor's economic, social and foreign policy. Structural adjustment programmes (SAPs)¹⁰ and poverty reduction strategy papers (PRSPs)¹¹ were key instruments used to compel developing countries to conform to neoliberal policies (Bakker & Gill 2003:48). Debtor countries' economic, social and foreign policies came under World Bank and IMF scrutiny (Brodie 2003:60). Foreign aid had become the tool to promote neoliberal ideology in many developing countries.

In many developing countries, the effect of unsustainable borrowing, increasing balance-of-payments problems, and mounting budget deficits meant that they were heading towards economic collapse and bankruptcy. In the early 1980s the world was in a

prolonged recession, and interest rates skyrocketed. In 1982 Mexico was the first country to begin to default on its loans, and soon other developing countries followed. The magnitude of the debt crisis was so great that it threatened to bring down the global financial system (McMichael 2004:134), and effectively put the development process and poverty reduction strategies on hold. Before these could be resumed, developing countries were forced to 'put their houses in order' through SAPs. The 1980s ushered in the era of economic stabilisation and structural adjustment. Development was temporarily blocked and the era became known as the 'lost development decade' (Thorbecke 2000:33)

2.4 THE LOST DEVELOPMENT DECADE (1980s)

2.4.1 DEVELOPMENT AND ECONOMIC THEORY IN THE 1980s

Development in the 1970s was based on meeting people's basic needs and redistributing growth. In the 1980s neoliberal ideology became the basic development model, and foreign aid, in the form of SAPs, based on neoliberalism, largely replaced the rural-based development projects of the 1970s. Neoliberalism (also known as the Washington Consensus) used foreign aid to force developing countries to adopt a liberated market economy. The Washington Consensus was 'consensus' between World Bank, IMF and the US Treasury about the 'right' policies for Third World development.¹² These new neoliberal policies were a radical approach to economic growth and development. The Washington Consensus was a fusion of IMF macro economic policy and World Bank market liberation, coupled with US enthusiasm for the privatisation of state enterprises (Taylor 2007:454). The neoliberal policies and development strategies focused on macro stability (particularly price stability), market liberation, the privatisation of state enterprises and reduction of the role of the state (Stiglitz 2002:16). According to Stiglitz (2002:16), governments in developing countries, particularly highly indebted countries, were forced to accept

structural adjustment programmes underwritten by foreign aid. Foreign aid was being used to endorse the neoliberal ideology in the developed world. Key features of neoliberalism were its neglect of alternative market approaches and its complete disregard for criticism of its policies and theory (Fine, Lapavistas & Pincus 2003:4). Many donors, following the lead of the World Bank and IMF, insisted that recipient countries accept the terms and conditions of these institutions before they released foreign aid. In many highly indebted countries, donors took their cue from the IMF and provided aid only if a recipient country adopted the neoliberal policies and measures recommended by the World Bank and IMF. In contrast with the 1970s, when development policy was focused on rural poverty and the role of the state in reducing poverty, the solution in the 1980s was to reduce the intervention of the state to a minimalist position. In the 1980s foreign aid was used to promote policies that were counterproductive and worked against the development and economic theory emerging in the late 1970s. Neoliberalism did not succeed in stimulating economic growth in many underdeveloped countries; nor did it reduce poverty.

By the early 1990s the neoliberal economic model was increasingly questioned. During the Washington Consensus era, the world economy slowed down, and the gap between developed and underdeveloped countries increased. The divide within the Third World itself continued to grow. The strong and rapid economic growth of the newly industrialised countries (NICs) in Asia was in stark contrast to the steady economic decline in many sub-Saharan African countries. The rapid development and economic growth of the NICs were hailed by the international finance institutions (IFIs)¹³ as examples of the effectiveness of their neoliberal strategies. Further investigation, however, revealed that the success of the NIC countries was based on state intervention (not a minimal state, as proposed by neoliberalism) and an appropriate balance between state intervention and the market. NIC economic strategies included a combined focus of import substitution and export

promotion. The NIC experience demonstrated the important role the state must play in development (Onis & Senses 2007:260). Neoliberal principles, according to Onis and Senses (2007:262), however, produced only a few successes, and even these successes did not completely follow the strict neoliberal economic model. The contrast between Russia's transition to a market economy and that of China could not be more stark. The IMF managed the Russian economy, while China designed its own transition. In 1990 for example China's GNP was 60 per cent of the Russian GNP, but by the end of the decade the numbers had been reversed. Russia, under IMF supervision, experienced an increase in poverty, while China, without IMF influence, underwent a steady decline in poverty (Stiglitz 2002:6). The remedies measured out by the Washington Consensus institutions did not reduce poverty, resolve the economic crisis, or counter rising debt in many developing countries (Fine et al 2003:4). But despite the apparent failures of the Washington Consensus in the 1980s, foreign aid was still used to underpin the implementation of the neoliberal model for economic growth and development in many developing countries.

2.4.2 THE ROLE OF FOREIGN AID IN THE 1980s

By the end of the 1980s, debt in developing countries was a staggering US\$1 trillion, and the cost of debt servicing was so large that the outflow of debt payments dwarfed the inflow of foreign aid. There was a net reverse flow of capital from developing countries to developed countries. In 1987–1989 the net capital outflow from developing countries to developed countries was \$15 billion. The reversal of net aid flows added to the huge indebtedness in many poor countries (Brown, in Thorbecke 2000:38). The 1980s ushered in a gradual decline of aid (measured as a percentage of GNP). In the mid 1980s total aid averaged around 0.35 per cent of GNP and by 1996 aid had shrunk to 0.25 per cent of

GNP (Eurostep 1997, in Hewitt 2000:301). The debt crisis of the 1980s dramatically changed the purpose of foreign aid.

The debt crisis in the 1980s changed the model and role of foreign aid in a number of important ways. The primary objective of foreign aid switched from growth and development to an emergency measure to salvage a collapsing global financial system. Foreign aid was used to ensure that developing countries were able to continue to service their public and private debts, thus keeping their creditors (developed countries and their commercial banks) afloat, and preventing an economic meltdown in the developed world. Foreign aid was used to force the adoption of neoliberal free-market policies through conditionality attached to aid lending and donor funds (Easterly 2006:202). SAPs were designed to ensure quick short-term improvements in the balance of payments, and to protect the interests of international banks, irrespective of the cost to the recipient's economy (South Commission 1990:67).

SAPs were designed to achieve three main objectives in the recipient country. First, recipient countries were forced to remove price controls, reduce state intervention in the labour market, and liberalise their financial markets. These measures tried to remove price distortions that produced market inefficiencies. By liberating the market and removing price controls, the market was able to determine prices and this reduced inefficiency. Second, recipient countries were compelled to remove import quotas, to reduce tariff duties, and to adopt floating exchange rates. Third, recipient countries were coerced into reducing the role of the state in the economy by drastically reducing government spending (mostly social spending) and privatising all state enterprises (Hewitt 2000:302). Foreign aid was used to underpin SAPs and stabilisation strategies in underdeveloped countries. Recipient countries in desperate need of foreign aid received it from donors, World Bank or the IMF,

only if they adopted neoliberal structural adjustment programmes (see example of Mozambique in section 4.2.1.3). The purpose of foreign aid in the 1980s switched from growth and poverty reduction to ensuring that poor countries continued to service their debts and not default on their loans. By using foreign aid to underwrite the SAPs and to protect the interests of the developed countries, the purpose of foreign aid changed. Instead of promoting growth, foreign aid was used to support the implementation of neoliberal policies and strategies, which caused economic contraction and stagnation in many developing countries (Hewitt 2000:302).

Structural adjustment programmes were therefore being used to shore up the failing global finance system and to ensure that poor countries paid their debts. Foreign aid was increasingly serving the interests of the donor countries, rather than the needs of the recipient country. If a portion of foreign aid is used to protect the economy of the donor countries, then it can be argued that the impact of foreign aid should not be measured against the indicators of economic growth in recipient countries. This is an important issue and we will return to the discussion of aid and donor motives in more detail in chapter 4.

2.5 STATE BUILDING AND PARTNERSHIPS (1990s to present)

The first half of the 1990s continued to be dominated by neoliberal SAPs. Although Latin America had gone through a difficult readjustment process and was on a growth path again, many economies in the developing world had stagnated. Weak governance plagued growth and development in sub-Saharan Africa. The economies of Eastern Europe were slowing down instead of growing. But in East Asia the miracle economies of the NIC – including South Korea, Taiwan, Singapore and Hong Kong – had shown significant sustained economic growth. The East Asian Miracle was a different model from the

neoliberal growth model. In the East Asian model, the market was managed by the state through guided credit, export support, investment coordination, and rewards to enterprising entrepreneurs. The East Asian model focused on developing human capacity, infrastructure, entrepreneurship and a culture of hard work (Hewitt 2000:307). In the mid 1990s it was thought that the NIC growth model could provide an alternative to the neoliberal model. However, in 1998 the sudden, unexpected and dramatic financial crisis in the East Asian economies shattered the optimism for the East Asian model of growth. The Asia financial crisis caused a major policy debate in both donor and policy-making circles, raising questions about the appropriateness of the East Asian model and the neoliberal policies being forced on developing countries. But with shrinking growth in Latin America and Africa, the 1998 Asian financial crisis, and the dramatic deterioration in the former Soviet republics, poverty was back on the development agenda. In the 1990s the foreign aid agenda began to include sector programme support to improve health, education, access to information, nutrition and participation in decision making (Thorbecke 2000:40).

2.5.1 DEVELOPMENT AND ECONOMIC THEORY IN THE 1990s AND 2000s

In the 1990s the Washington Consensus and the East Asian model of development were the dominant economic models for growth and development. In that decade the neoliberal agenda of the Washington Consensus began to soften, and the stringent faith in markets began to weaken. The late 1990s ushered in the Post Washington Consensus,¹⁴ which combined neoliberal economic theory with liberal democratic theory (Hewitt 2000:305). The East Asian Miracle and the crash of the East Asian markets in 1998 resulted in a critical evaluation of the East Asian model of development. In the 2000s the role of the state was revised, and the state was promoted not as a minimalist state, but as an enabler for development. The main development economic theories and models to emerge in this

period were the East Asian Model of development; the Post Washington Consensus (the revision of neoliberal economics); the debate about whether the neoliberal economic model (Washington Consensus or the Post Washington Consensus) were the 'right' models for developing countries; and finally the revised role of the state and NGOs as actors in growth and development.

In 1993 the World Bank published an influential report on the economic miracle of East Asian development. The report, which was an assessment of the high-performing Asian economies, argued that many of the lessons learnt in Asia could be transferred to other developing countries. Lessons for the East Asian model included (Stiglitz 2002:126–128):

- The importance of sound macroeconomic policy with strong institutions and stable exchange rates
- Political stability and technocratic regimes that ensured policy credibility and reduced risk (important factors to attract foreign investment)
- Export orientation
- Reliance on markets
- Industrial policies that included private sector competition and selective government intervention
- Priority on developing human capital
- High levels of savings and investment
- The acquisition of technology

Of particular importance was the export orientation of the Asian markets. Export orientation meant that the countries acquired state-of-the-art technology, which stimulated 'learning-by-doing' and 'learning-by-seeing'. This process resulted in a spill-over effect on human capital within and among industries (Thorbecke 2000:43). The Asian countries demonstrated the importance of sound institutions and the role of the state in growth. The

absence of institutions in Eastern Europe and the fragile institutions in sub-Saharan Africa provided contrasting counterfactual examples of the huge cost of weak governance and inadequate state institutions (Stiglitz 2002:128). But the crash of the Asian markets in 1998 cast doubt on both the East Asian and neoliberal models for economic growth.

The collapse of the Asian markets in 1998 resulted in a critical evaluation not only of the economic growth models, but also of the international trade and finance systems, which were based on excessive market liberalisation, poorly regulated financial markets and excessive trade, and were in urgent need of reform (Stiglitz 2002:178). The resultant poverty after the crash in Asia was a wake-up call to the development community to concentrate on poverty reduction and the improvement of people's wellbeing. By early 2000 the World Bank and other donors were focused on poverty reduction as the overarching goal of development. The 1998 Asian crisis also resulted in a critical examination of the role of government in development and growth. It was evident that government played a key role in protecting the economy from shocks and ensuring that there were at least minimum standards in place to regulate the banking sector, reduce corruption, and minimise speculative borrowing. Government had a responsibility to provide institutional safety nets that could stabilise the economy after an economic shock (Thorbecke 2000:44; Stiglitz 2002:128). Critics argued that even if the East Asian model were to be emulated in other developing countries, it was unlikely to succeed, because it requires a strong state: a component that was missing in many other developing countries (Thorbecke 2000:40). After the economic failures in Asia, Eastern Europe and Russia, neoliberal policies (Washington Consensus) were reformulated into the more moderate Post Washington Consensus. In the Post Washington Consensus the state, civil society, and state institutions played a more important role in economic growth and development.

In the early 2000s the Post Washington Consensus emerged in response to the failures of neoliberalism. It focused on getting fundamental governance right (Stiglitz, in Fine et al 2003:3). The revised principles included sound economic policy, improved health and education, the rule of law, good infrastructure, and environmental protection. The state played a key role in promoting industrial policy, and appropriate regulation, and ensuring that welfare systems were in place. In the Post Washington Consensus, government intervention was guided so that the state complemented the market. Government's role was to ensure that the market could fulfil its potential (Fine et al 2003:3). The Post Washington Consensus recognised the important role of the state in development and continued to support market liberation and a greater reliance on the market, but with the state as an enabling component in the market. The role of the state was crucial in supporting, stabilising and legitimising the market. Sound financial regulation was vital when mobilising capital, and boosting investor confidence in the banking system (Onis & Senses 2007:269). In the late 2000s there began to emerge a critical analysis of the neoliberal policies, which argued that these were not the 'right' policies for economic growth and development in developing countries.

In the 2000s critics began to contend that the neoliberal economic model, whether it was the Washington Consensus or Post Washington Consensus, was not the most appropriate model for economic growth and development. Stiglitz (2002, 2006), Reinert (2007) and Chang (2007) for example all argue that it was the interventionist role of the state that made the difference in East Asia and that the policies of the Washington Consensus were hindering growth, rather than promoting it, in many developing countries. The policies being forced on the developing world were the wrong ones, and no amount of foreign aid would correct the implementation of flawed policy. Reinert (2007:xxvii) argued that neoliberalism as promoted by the donors, and the use of foreign aid to enforce their

policies, will not create development and growth, but instead will lead to a form of welfare colonialism where the rich countries maintain political and economic dominance over poor countries. Foreign aid was not having a positive impact on growth, because the growth pattern and policies promoted by donors did not foster development, but created a dependent state in the form of welfare colonialism (Reinert 2007:xxvii). In Korea the interventionist state used measures such as tariff protection, subsidies, and cheap credit to protect and nurture emerging industries from stiff external competition, but these measures were utilised for a limited time only. This interventionist strategy was maintained only long enough for the industries to absorb new technology, and to develop technical skills and the capacity to compete on the global market. The Korean economic miracle was a blend of state intervention and market incentives. The private sector in Korea was encouraged to make profits and prosper (Chang 2007:15). But Korea was not an exemption to the rule. Nearly all developed countries – including Britain, US, Sweden, and Denmark – used tariffs and quotas to protect local industry. Industries in these countries received (and many continue to receive) subsidies to sustain their growth and development. These developed countries resisted direct foreign investment that could threaten the local industry. Chang (2007:17) emphasised that for a long time Britain and the US were two of the most protected economies in the world. There is a clear argument to be made that the policies being forced on developing countries by donors and the IFIs are wrong and are contributing to the maintenance of developing countries as the producers of raw materials, and thus unlikely to industrialise. This is a hotly debated topic that is beyond the scope of this thesis, but suffice it to point out that the strict neoliberal policies being promoted and funded by foreign aid are unlikely to yield positive impacts on economic growth or social development.

The Post Washington Consensus recognised that the role of the state was important for economic growth and development. The state was critical to ensuring an 'enabling' environment where markets function more effectively. While the debate on the correct form of state intervention and the reliance on markets continues, the neo-institutional and public choice concepts have to some extent clarified the role that the state can play in development. According to neo-institutional and public choice theory, the state can provide an enabling environment for economic growth and development. The state can achieve this in three ways. First, it should provide the institutional infrastructure – for example property rights, the rule of law, a functioning judiciary, and a peaceful environment – that encourages investment and growth. Second, the state can provide both the macro and micro economic incentives necessary to stimulate economic growth. Finally, the state, by ensuring the delivery of basic services such as education and health and infrastructure development, can provide the necessary components for economic growth and development (Commander Davoodi and Lee in Thorbecke 2000:40). Markets were still seen as the most appropriate driver for economic growth and service provision, while the state played a more enabling role in economic growth and development.

The role of NGOs also changed in the late 1990s and 2000s. NGOs were seen as appropriate vehicles for providing welfare services to those sectors of the population that were not reached by the markets and increasingly became instruments for the democratisation and strengthening of civil society. Hewitt (2000:305) pointed out that while neoliberalism continued to play an important role in shaping development economics, markets on their own did not bring universal benefits. Economic liberalisation continued in most developing countries – no longer as SAPs, but as poverty reduction strategies (PRSs), which incorporated the capacity building of state institutions, governance and the

role of civil society. Partnership began to replace conditionality, and poverty reduction started to rise as a significant objective for foreign aid.

2.5.2 THE ROLE OF FOREIGN AID IN THE 1990s AND 2000s

Foreign aid continued to support the implementation of the neoliberal agenda, but, after several economic failures in the late 1990s, foreign aid steadily declined. After the 1998 East Asian crisis, foreign aid flows followed the development model of the Post Washington Consensus. Foreign aid switched away from investment in economic infrastructure and the productive sector, and was increasingly channelled into supporting the development of the enabling state. The biggest influence on foreign aid policy was the introduction of the Post Washington Consensus model for development and the switch from *ex-ante* conditionality to *ex-post* conditionality.

From the mid 1980s and until the late 1990 donors provided foreign aid based on ex-ante conditionality (SAPs). Ex-ante conditionality is a process in which donors lay down conditions for their loans, and recipients are obliged to accept and implement these conditions. Conditionality is a bargaining process between recipient and donor. Both sides have a vested interest in winning the high stakes bargaining game. The donor's agenda is mostly political, and recipients are generally hostile to conditionality, which they perceive as an infringement of their sovereignty. But recipients soon learned to play the conditionality game and successfully outmanoeuvred donors on numerous occasions. In 1995 *The Economist* eloquently described the aid conditionality game (in Sogge 2002:127).

Over the past few years Kenya has performed a curious mating ritual with its aid donors. The steps are: one, Kenya wins its yearly pledges of foreign aid. Two, the government begins to misbehave, backtracking on reform and behaving in an authoritarian manner. Three, a new meeting of donor countries looms with exasperated foreign governments preparing their sharp rebukes. Four, Kenya pulls

a placatory rabbit out of the hat. Five, the donors are mollified and the aid is pledged. The whole dance starts again.

According to Sogge (2002:127), donors pretended to enforce conditionality and recipients pretended to comply with it. Recipient governments were well aware that donors needed to move their aid dollars – after all, the aid system is about moving money. Donors could threaten to cut off aid, which is possible, but unlikely. Both donors and recipients have a direct interest in defining conditionality that is politically and economically digestible.

The poor performance of foreign aid and the economic crises of the late 1990s led to criticism of the Washington Consensus model, particularly SAPs and aid conditionality. Researchers increasingly began to evaluate the links between conditions in recipient countries and their economic policy. Burnside and Dollar (2000:845) found that aid had an impact on growth, but only in countries with a good policy environment. Burnside and Dollar (2000:845) introduced ex-post conditionality as a possible solution to the ineffectiveness of foreign aid. Ex-post conditionality rewards recipients for progress in policy reform. The Burnside and Dollar (1998a) recommendation was sharply criticised in the literature (see section 3.5.1 for a detailed discussion), but despite this, it was precisely the evidence donors needed to make the switch from ex-ante to ex-post conditionality.¹⁵

Donors changed over from ex-ante conditionality to ex-post conditionality in order to improve the performance of foreign aid at macro economic level. The transition from the Washington Consensus model to the Post Washington Consensus model meant that donors turned their attention to other strategies to support their macro economic aid. In the 1990s foreign aid was used to support sector-wide programmes; policy dialogue; and capacity building in civil society (Degnbol-Martinussen & Engberg-Pedersen 2003:49). The sector-wide approach (SWAps) is a form of programme aid directed to particular sectors of

the country's development strategy. It is an attempt by donors to improve harmonisation, reduce project fragmentation and proliferations, and increase recipient ownership of development and growth strategies. SWAps are a sector-based collaboration between the recipient country and the donors, a response to the negative impact of SAPs, and an alignment to the Post Washington Consensus model of development. SWAps can be seen as reducing costs, concentrating foreign aid to tangible results, and increasing technical assistance in order to develop the capacity of recipient institutions (Degnbol-Martinussen & Engberg-Pedersen 2003:50). The SWAps approach differs from the project-based approach in which individual donors support specific activities within a particular sector. In the SWAps, government and donor funding for the sector (for example agriculture) are pooled and directed towards the achievement of the sector strategy. Government and donor resources for the sector support an agreed sector policy and expenditure programme. SWAps have the theoretical advantage of donor programme harmonisation, and coordination monitoring, and the recipient country leads the process and its implementation (Eldis 2011:1).

In the 1980s, policy dialogue took place principally between the recipient and the World Bank/IMF, but by the 1990s donors increasingly began to engage with recipient governments in policy dialogue. Donors, by providing SWAps and forming donor groups, were able to increase their influence in policy dialogue with the recipient governments (Degnbol-Martinussen & Engberg-Pedersen 2003:50). In Mozambique for example the main donors are organised through a group of nineteen donors ('G19'). G19 uses a common framework and interfaces with the government of Mozambique through a donor 'board', known as the Troika (DFID 2008:20). This strategy may increase donor harmonisation, but it also increases donor leverage and influence over the recipient government. Donors use foreign aid as a tool to ensure that neoliberal policy and reform

are implemented in recipient countries. SWAps, coupled with direct budget support and the World Bank/IMF loans provided on ex-post conditionality, have significantly increased the power that donors leverage over recipient governments.

With the transition from SAPs to direct budget support (macro economic aid) and the introduction of SWAps (sector programme aid) donors gained significant influence over recipient countries' policies and strategies. Additionally, through the introduction of poverty reduction strategies (PRSs), donors began to channel aid resources into building the capacity of special groups and civil society within recipient countries. Donors made demands for democracy, multiparty elections, observance of human rights, and increased involvement of civil society in political decision-making processes. Foreign aid was used more and more to strengthen the power and resources of special target groups within civil society. This was a shift in aid strategy away from targeting the powerless and marginalised groups of the 1970s and 1980s to donor-led civil society groups influencing the recipient policy and economy along the principles of the Post Washington Consensus.

In the 1990s and 2000s, donors have increasingly used foreign aid to reinforce the neoliberal policy agenda in recipient countries. There has been an important shift in the donors' approach to foreign aid, for example direct budget support and SWAps. Ex-post conditionality has effectively increased donors' power and leverage over recipient governments.

2.6 CONCLUSION

This chapter traced the evolution of development economic theory in order to set the theoretical framework for this study. Particular attention was paid to the trends that

influenced the allocation of foreign aid. The narrative traced the evolution of development economic theory and the role of aid from the 1950s through to the early 2000s (divided into decades), drawing out the main concepts, and explaining how they influenced the allocation of foreign aid.

Foreign aid emerged in the late 1940s, based on the optimistic view that it could promote development and growth in underdeveloped countries simply by providing these countries with capital to fill their savings and investment gaps. In the 1960s, the two-gap model identified a second gap, namely the foreign exchange gap, as a further hindrance to growth. Donors believed that foreign aid could fill these two gaps, and that recipient governments would plan and use aid capital effectively. Foreign aid did not meet expectations and by the early 1970s poverty was increasing, and many developing countries were experiencing declining growth.

By the 1970s it was evident that modernisation and the concepts of a big push, trickle-down effect and take off to growth were irrelevant in most developing countries. The 1970s ushered in the transition from macro economic urban-based industrialisation to rural-focused IRD and BNA approaches to poverty alleviation and development (see section 2.2.6). In the 1970s, foreign aid increasingly targeted the rural poor, who until the early 1970s had largely been neglected by aid. Aid was provided to developing countries as a 'project package' instead of the large capital flows of the 1950s and 1960s, but even this strategy produced dismal results.

The 1980s and the ensuing debt crisis resulted in the development model switching from rural poverty alleviation back to macro economics and saw the introduction of SAPs. The 1980s was the lost decade of development as poverty alleviation was replaced by

neoliberalism in the form of SAPs (see section 2.4.2). Developing countries were forced to 'put their houses in order' through tough SAPs and conditionality. Foreign aid was used to ensure that developing countries continued to service their debts and implement neoliberal macroeconomic policies. In the 1980s aid fatigue began to set in and aid to developing countries shrank from 0.35 per cent GNP in 1980 to 0.25 per cent GNP by 1996.

The 1990s continued to be dominated by SAPs. In the early 1990s there was significant reflection on the East Asian miracle countries and the development models used by countries such as South Korea, Taiwan and Singapore. But the East Asian crisis in 1998 gave rise to a reappraisal of the East Asian model of development. The Post Washington Consensus emerged in the early 2000s as a response to the failures of SAPs and the economic disasters in Eastern Europe, Russia and East Asia. The Post Washington Consensus focused on correct fundamental government principles, acceptance that the state had a role to play in development, and a strong belief that development was based on free market principles. In the 1990s the question of policy, governance and institutional capacity became more and more significant. In the early 2000s donor aid allocations, following the trends in development and economic theory, began to shift from ex-ante conditionality to ex-post conditionality. Donors increasingly channelled their aid to countries that were reforming their economic policies along the neoliberal model of free markets.

The following chapter briefly analyses the aid effectiveness literature in an attempt to answer the important questions 'Does aid work?' and 'Is aid effective'? Chapter 3 also extracts from the literature the major variables that influence the impact of aid on economic growth and development. These variables are important as they help to explain why aid appears to have been less effective than anticipated.

NOTES

¹ Domestic savings are a combination of private, public (budget surplus) and net foreign savings (net investments including foreign investment and aid).

² These two models are mentioned, but not discussed, since they did not influence the allocation of foreign aid to the extent that the growth and gap models affected growth.

³ Only the two-gap model is discussed, as it was the most influential model in the aid sector.

⁴ The foreign exchange gap was also referred to as the 'trade balance gap'.

⁵ See section 2.2.2 and 2.2.4 for a detailed discussion on the growth models.

⁶ This is referred to as 'aid fungibility', in which governments replace own income with aid, and then use the freed-up income to fund non-productive or wasteful expenditure, for example military expenditure,

⁷ The goal standard meant that the US Treasury paid creditor central banks for current account deficits with bars of gold. That is, the US paid its creditors in gold. This strategy constrained spending and maintained the value of the US dollar at a fixed rate. (Linden 2007:183).

⁸ Richard Nixon was the 37th president of the United States (1969–1974).

⁹ 'Neoliberalism' is the political view that emphasises the importance of economic growth. Neoliberalism supports the theory that economic growth is promoted through the liberation of markets (including financial markets), minimal involvement of the state, and privatisation of state assets, and emphasises that social equality and development are best served with minimal state interference and the promotion of free markets

¹⁰ The World Bank and the International Monetary Fund (IMF) introduced SAPs in response to the debt crisis in the early 1980s. The goal of an SAP is to provide bridging finance to developing countries to ensure that their debts are serviced. The SAP introduces strict austerity measures designed to improve the recipients' economic policies, tighten government spending, reduce budget deficits, lower inflation to single digits and lessen the volatility of exchange rates. Since many developing countries are heavily indebted, they have little option other than to comply with the strict policies and measures of an SAP. The World Bank and IMF are thus able to force recipient countries to adopt economic policies and measures that they and their people oppose.

¹¹ 'A PRSP describes the macroeconomic, structural, and social policies and programs that a country will pursue over several years to promote growth and reduce poverty, as well as external financing needs and the associated sources of financing. They are prepared by governments in low-income countries through a

participatory process involving domestic stakeholders and external development partners, including the IMF and the World Bank' (IMF 2011:1).

¹² The 'right' policies in this context are the neoliberal policies of liberalised markets, reduced protection, no subsidies and a minimalist state – conditions with which developed countries themselves do not comply.

¹³ International finance institutions include World Bank, IMF and WTO.

¹⁴ In some circles the Post Washington Consensus is referred to as the New Policy Agenda (NPA). See for example Hewitt (2000:305).

¹⁵ Ex-post conditionality meant that donors rewarded countries that they deemed to be implementing the 'right neoliberal economic policies'.

CHAPTER 3: ANALYSIS OF AID LITERATURE

3.1 INTRODUCTION

The aid effectiveness debate began in the late 1950s and has continued to produce a series of cyclic and hotly contested arguments in the literature. The cycle usually follows an 'Aid works', 'No, it doesn't work', or 'Aid works, but it depends' sequence. If one conducts a brief review of the literature, selecting the work of renowned economists such as Easterly, Collier, Dollar, Roodman, Hansen and Tarp, one finds so many contradictions and conflicting opinions that one is left with the feeling that no one truly knows whether aid is effective or not.

In this chapter we explore a selected sample of the vast aid effectiveness literature. This analysis is divided into four historical phases, which follow the relevant development theories. The first phase of research focused on the impact that aid had on savings, investments and growth. This roughly covered the period 1950 to 1975 (see section 3.2). During the second phase, research began to focus more on the effect of aid on growth (see section 3.3). This phase covered the period roughly from 1975 to 1995. In 1996 Boone published a controversial paper that contended that foreign aid continued to have a negative impact on growth (see section 3.3.1). When one considers Boone's research and conclusion in the context of development history; the debt crisis of the 1980s; the economic failures in the 1990s in Asia, Eastern Europe and Russia; plus the growing aid fatigue in developed countries; it is little wonder that it created the reaction that it did in development circles. Boone's conclusion was a critical finger pointing directly at the heart of the aid industry. The following year Burnside and Dollar (1997)¹ published a research

study that proved that aid had a positive impact on growth, but only in countries with a good policy environment. Burnside and Dollar (2000:847) therefore recommended that aid should be given only to developing countries with good policies. The Burnside and Dollar recommendation provided the donors and supporters of foreign aid with the evidence they needed at a time that aid was being publicly criticised and there were high levels of aid fatigue in many circles. Here was scientific evidence as to why aid was not working, and a recommendation on how foreign aid could be reformed. The Burnside and Dollar assertion that aid works better in a good policy environment, according to Riddle (2007:231), is reasonably self-evident, since aid is more likely to be effective when provided to recipients with an enabling environment. Conversely, aid is likely to be less effective when provided to recipients with unstable or poor policy environments. The Burnside and Dollar study instigated a long controversial debate in the literature, but more importantly their research paper had a far-reaching influence on the rules applicable to future allocations of foreign aid. During the third phase, research focused on aid, growth and policy, which was the most prominent debate in the literature from 1996 to 2003. The role of policy was important, since the SAPs of the IFIs and donors were based on the premise of improved macro economic policy and reduced spending (see section 2.4). The most recent phase (fourth phase) in the literature is an evolution of the aid, growth and policy debate, in which researchers have increasingly begun to study other variables influencing aid besides the policy variable (see section 3.5.2).

The sections in this chapter roughly follow the main development theories, which in turn influenced the themes debated in the literature. However, in practice these divisions are not so clear-cut and there is significant overlap among the phases. By the late 1990s for example, the literature had begun to study a number of variables that could explain why aid was not having the expected impact on growth and development. The division between

the third and fourth phases is not nearly so clearly defined as that between the first two phases, since, from 1995 onwards, the volume of aid effectiveness literature rose exponentially, and the research branched out to include a number of important variables that influenced the impact that aid had on growth and development. However, for the purposes of this study, the use of the four phases helps us to analyse and understand the impact that aid has had on growth and development. The divisions also allow us to determine what effect these variables may have on foreign aid, growth and development. If we isolate the variables that influence the impact of aid, then we can make recommendations on how aid could be made more effective.

3.2 PHASE 1: AID – SAVINGS, INVESTMENTS AND GROWTH (1950 to 1975)

By the mid 1950s, research papers began to emerge that attempted to answer the pressing questions, 'Is foreign aid effective?' and 'Does aid work?' There was a great deal of optimism in the 1950s that foreign aid could be used to stimulate growth and development in underdeveloped countries (discussed in section 2.2.3). The success of the Marshal Plan in Europe strengthened the belief that if foreign aid were provided to developing countries, they too would experience growth and development. Early growth theory suggested that developing countries were not growing economically because they lacked adequate domestic savings, and therefore their investment levels were too low to stimulate growth (discussed in section 2.2.2). In addition to low domestic savings, many developing countries had inadequate reserves of foreign currency, which prevented them from investing in infrastructure, modern technology and capital equipment, which are all necessary components for industrialisation (see section 2.2.2; Morrissey 2001:40; Escobar 1995:75; Thorbecke 2000:22).

Early development economics assumed that foreign aid would supplement domestic savings and provide foreign exchange to boost growth. According to the early two-gap theory (section 2.2.4), foreign capital inflows (including aid) would fill the savings and exchange gaps (Hansen & Tarp 2000:106). However, providing foreign aid only to fill the gaps would not be enough. Aid had to be used for productive investments and not wasted or used for public consumption. It was evident that the impact of aid, to a degree, would be determined by the recipient governments and how they used aid capital.

In early development economic theory, it was assumed that aid would automatically be allocated to increase domestic savings and productive investments (see section 2.2.3 and 2.2.5). Researchers in the early 1950s and 1960s ignored aid fungibility² and assumed that all foreign aid was allocated to savings and productive investment (Hansen & Tarp 2000:105). However, providing aid to developing countries was only part of the solution. The way in which aid was used had a significant impact on its ability to stimulate growth and development. If aid was used for productive investment, then the early models predicted that aid would contribute to growth, since aid provided the additional savings and foreign currency to import technology, capital equipment; spare parts and inputs (see section 2.2.3 and 2.2.5). But aid did not function in a vacuum. If there were reductions in export earnings for example, this could negatively offset any growth advances aid might have made. Or if recipient governments used aid to fund recurrent public expenditure (consumption), instead of investing in productive economic activity, then the impact of aid would be further reduced (Gomanee, Giram and Morrissey 2005a:300).³ The research in the 1950s and 1960 sought to determine whether aid was being used effectively, and whether aid was stimulating an increase in domestic savings, investments and therefore causing economic growth in the recipient country.

3.2.1 ANALYSIS OF THE IMPACT OF FOREIGN AID (1950 to 1975)

The early growth models were simplistic and based on the fundamental economic principles of early modernisation theory (discussed in sections 2.2.2, 2.2.3 and 2.2.4). Economic models such as the Harrod-Domar and two-gap model assumed that underdeveloped countries needed only an injection of capital to stimulate their growth and support their run-up to economic take-off. The reality, however, has been quite different. In hindsight we can look back over nearly 50 years of foreign aid, and ask whether aid has had any impact on growth and development. The question is, Did foreign aid achieve its objective to promote growth and development, or is economic growth more complex than the early models predicted? Research in the 1950s and 1960s focused only on the impact of aid on savings, investments and growth. An analysis of the key studies from the period (1948 to 1975) reveals interesting insights into the impact that foreign aid had (or did not have) on growth and development.

In the early literature, studies on aid assumed that for each dollar of aid, a net increase of one dollar in savings and investments would result (see section 2.2.2 and 2.2.3) (Rosenstein-Rodan 1961, in Hansen & Tarp 2000:105). Analysis in the 1960s and 1970s was restricted by untried theory, limited data, and new research methodology with untested specifications and formulae construction. In the next section we briefly review the key studies of the 1960s and early 1970s.

Domar (1947) and Rostow (1956), founders of early modernisation theory (see section 2.2.1), both supported the argument that foreign aid could be used to boost domestic savings, which in turn would stimulate economic growth (in Clemens et al 2004:4).⁴ Friedman (1958), however, predicted that the 'new aid programmes would not lead to economic growth' (in Hudson & Mosley 2001:1023). By the late 1960s, continued

underdevelopment and emerging research began to demonstrate that foreign aid was not delivering on its promise of sustained economic growth in underdeveloped countries.

Research published in the late 1960s and early 1970s generally found that aid had a negative impact on savings, investments and growth (see table 3.1 below). For example, Rahman (1968, in Hansen & Tarp 2000:105) found that aid had a negative impact on domestic savings. Similarly, Gupta (1970) found that aid had no impact on domestic savings (in McGillivray et al 2006:1034). Not only did Griffin and Enos (1970) find that aid had no impact on domestic savings, they observed that aid had a negative impact on growth. Griffin and Enos (1970) substantiated their negative growth conclusion by demonstrating that foreign aid in many recipient countries was used for public consumption instead of productive investments (in McGillivray et al 2006:1034).⁵ Building on the earlier research, Bauer (1972, in Singh 1985:217) found that aid had 'little effect on growth' and Weisskopf (1972 in Clemens et al 2004:5) similarly found a negative relationship between aid and domestic savings.⁶ In table 3.1 below it is evident that Bauer (1972) and Weisskopf (1972) supported the earlier negative conclusions of Rahman (1968), Griffin (1970) and Griffin and Enos (1970), who all found that aid generally did not have any impact on savings, investment or growth (in Clemens et al 2004:5). But not all research papers drew such negative conclusions.

Papanek (1973), studying foreign aid of the 1950s and 1960s, refuted the earlier negative conclusions.⁷ Papanek (1973:129) found that savings (aid, private investments and other capital inflows) had a positive effect on growth, and that savings accounted for over a third of growth, thus confirming the theory of the early growth models (see section 2.2.2, 2.2.3 and 2.2.4). Papanek (1973:129) noted that aid had a 'more significant effect on growth than savings or any other form of foreign income'. But Papanek was the minority voice in

the debate. Later that year, Viovodas (1973) found that aid had a negative impact on growth. Viovodas (1973, in Durbarry et al 1998:2), sampling 22 least developed countries (LDC) between 1956 and 1968, found that aid had a negative impact on growth, but cautioned that the aid/growth relationship in his study was fragile. However, consensus, summarised in table 3.1 below, was that in the first phase (1950 to 1975), foreign aid did not have a positive impact on domestic savings, investments or growth. Two additional pieces of evidence confirm that in the first phase aid did not have any significant impact on growth and development. The first is found in two studies by Hansen and Tarp (2000) and McGillivray et al (2006). The second is in the interpretation of the early growth models and the studies relating to domestic savings and investments.

In evaluations of foreign aid during the first phase (1950–1975) Hansen and Tarp (2000) and McGillivray et al (2006) corroborated the earlier negative conclusion. Both studies found that foreign aid did not have a positive impact on growth or domestic savings. Hansen and Tarp (2000:110) found that, first, there was no evidence of aid having a positive impact on growth and, second, the early evidence showed that while aid did lead to some increase in domestic savings, the level of domestic savings did not match the inflow of foreign aid. Similarly McGillivray et al (2006:1032) found that aid had no impact on domestic savings and in some cases even displaced domestic savings. McGillivray et al (2006:1032) also found that in the early period, foreign aid had no impact on growth. Hansen and Tarp (2000) and McGillivray et al (2006) therefore confirmed the earlier negative conclusion.

Further evidence is hidden in table 3.1⁸ below, which is a summary of the key papers from 1950 to 1975), and confirms that during the first phase foreign aid had no impact on growth and development.

Table 3.1: Selected aid effectiveness studies up to 1975

Selected aid effectiveness studies up to 1975		
Authors	Year	Results
Domar	1947	Positive impact on growth
Rostow	1956	Positive impact on growth
Friedman	1958	No impact on growth
Rahman	1968	Negative impact on domestic savings
Gupta	1970	No impact on domestic savings
Griffin	1970	Negative impact on savings – aid used for public consumption
Griffin	1970	Negative impact on growth
Griffin	1970	Aid creating disincentive for government to increase tax income
Griffin & Enos	1970	Negative impact on growth
Griffin & Enos	1970	No impact on domestic savings – aid used for public consumption
Bauer	1972	No impact on growth
Weisskopf	1972	Negative impact on domestic savings
Papanek	1973	Positive impact on growth
Viovodas	1973	Negative impact on growth

In table 3.1 above,⁹ three studies concluded that aid had a negative impact on growth,¹⁰ two studies found that aid had no impact on growth,¹¹ and three studies found that aid had a positive impact on growth.¹² But the confirmation of the negative growth conclusion is in the studies that found that aid had a negative impact of domestic savings. Three studies found that aid had a negative impact on domestic savings,¹³ and two more studies found that aid had no impact on domestic savings.¹⁴ If one refers back to economic theory (see sections 2.2.2, 2.2.3 and 2.2.4) and the underlying Harrod-Domar growth model,¹⁵ one can find the evidence to support the conclusion that foreign aid had no impact on growth and development. The Harrod-Domar growth models assumed that foreign aid would fill the savings gap and therefore contribute to growth. Based on the theory, one can therefore argue that any studies that found aid to have a negative impact or none on savings could be regarded as evidence that aid had no impact on growth. If aid did not have an impact on savings, then, according to the gap models, aid failed to fill the savings gap. Therefore

it would not have had any significant impact on growth. It is with this in mind that I concur with Hansen and Tarp (2000) and McGillivray et al (2006), and conclude that in the period up to 1975 foreign aid had little or no impact on growth and development. The growth targets that donors and recipients imagined could be achieved only if the country was 'drowned in aid' (Griffin 1970:108).

3.2.2 EMERGING VARIABLES (1950 to 1975)

When researchers found that aid was not producing the expected results, they turned their attention towards other variables that could influence the impact of aid on savings and growth. During the first phase, research focused on the effect of aid on domestic savings and investments. The studies then began a more comprehensive evaluation of foreign aid by assessing the impact of aid on growth – after all, the idea of aid was to stimulate growth, and not just savings.

Griffin (1970:103) observed that while aid might discourage domestic savings, it also seemed to displace investment, and was being redirected into public consumption rather than productive investment.¹⁶ Recipients might be tempted to divert aid funds from investments to fund public consumption or non-developmental expenditure. Griffin (1970:106) and Griffin and Enos (1970) noted that the recipient government in an aid-rich environment could easily expand expenditure to include public consumption. By using aid money to fund savings and investments, recipients could use their own funds to finance public consumption (aid fungibility; see section 4.3.3). The net result was that aid displaced public savings, which resulted in aid having a negative impact on savings. Griffin (1970) was also one of the first researchers to raise the question of aid fungibility. Griffin (1970:103–106) not only noted that aid was being allocated for public consumption, but observed that there was a decline in tax income, therefore reinforcing the dependency on

aid. In the first phase, three new variables emerged from the literature. First, aid was being used for public consumption instead of productive investment. Second, aid funds were being diverted or displacing government funds in order to pay for non-productive investments (aid fungibility). Third, aid was reducing government's incentives to save and increase their own funds through more robust tax collection. While foreign aid was not having any significant impact on growth, new problems were emerging. Aid was fungible: it could be used to fund public consumption and not investment, and it was reducing the recipient governments' incentives to increase tax income.

3.3 PHASE 2: AID AND GROWTH (1975 to 1995)

In the second phase (1975 to 1995), researchers turned their attention from the aid-savings and aid-investments relationship to focus more on the aid-growth relationship. The underlying structural models continued to be the Harrod-Domar and the two-gap growth models (see sections 2.2.2, 2.2.3 and 2.2.4). The rationale was that filling the savings and investment gaps would increase economic growth. If a positive relationship could be found between aid and investment, then it could be concluded that aid had a positive impact on growth (Hansen & Tarp 2000:110). Papanek (1973) proposed that the aid effectiveness debate should turn from the focus on savings to an analysis of the relationship between aid, investments and growth. Papanek developed a model in which the various financing components of investment (domestic savings, aid and other foreign capital) were disaggregated (in Hansen & Tarp 2000:111).¹⁷ The second category of analysis focused directly on the link between aid and growth, using reduced form equations.¹⁸ The reduced form regression used the Solow-type model, while the regressions developed initially by Papanek were based on the Harrod-Domar growth model (Hansen & Tarp 2000:112).¹⁹ During this period there was also a significant increase in the number of variables that

were identified as being important to aid and growth, which will be discussed in more detail in chapters 4 and 5.

3.3.1 ANALYSIS OF THE IMPACT OF FOREIGN AID (1975 to 1995)

The second phase (1975–1995)²⁰ was dominated by studies that focused primarily on the aid-growth relationship. There was interest in the impact of foreign aid on domestic savings and investments, since donors continued to provide foreign aid capital in order to promote growth and development. During this period, donor policy was still influenced by the early growth models (see section 2.2.5), despite evidence that aid had little impact on domestic savings, investments or growth (see section 3.2.1). In the early 1970s, as discussed in section 2.2.7, donors increasingly began to switch their aid from direct budget support to sector- and project-based aid to sustain the IRD and BNA models of development. In the rest of this section we evaluate the impact of aid, based on a sample of the most frequently cited papers from this period. Interest in the relationship between the aid-savings and aid-investment link continued, but the research focus was increasingly on the relationship between aid and growth. To a lesser extent, there was new interest in comparing the impact of aid at project (micro) and country (macro) level. This new interest is not surprising, considering that aid was increasingly being switched away from direct budget support to project aid and rural development (see section 2.2.7). In the remainder of this section, we will briefly evaluate studies that focused on the impact of aid on projects, investments, and savings and conclude with an evaluation of the aid-growth studies.

Mosley et al (1987:635) introduced the ‘micro-macro’ paradox in which they found that aid had a positive impact at project (micro) level, but results were more ambiguous at macro level, leading them to conclude that there was a micro-macro paradox with respect to the

impact of aid on growth. Similarly, in table 3.2 below we see that Cassen and Associates (1986, in Durbarry et al 1998:5) and Landau (1990:5) found that project aid (micro) had a positive impact on growth. Mosley et al's (1987) micro-macro paradox and the findings of Cassen et al (1986) and Landau (1990) were not surprising, since donors were increasingly funding rural development projects, following the trend in development theory towards IRD and BNA models (see section 2.2.7). However, in the context of this study, which focuses on macro economic growth and development, we can ignore Mosley et al's (1987) micro-macro paradox and the studies of Cassen et al (1986) and Landau (1990), since their conclusions were focused on project aid (micro), while this study concentrates on the impact of aid on growth and development in recipient countries (not projects). Donors, although to a lesser extent, were still providing funds to fill the savings and investment gaps, and researchers continued to study the impact of aid on savings and investments.

Following the trend of the first phase (1950–1975), researchers kept on studying the impact of aid on savings and investments, and still found that no significant effect. For example, from table 3.2 we see that Singh (1985:230) found that aid had a negative impact on domestic savings. Similarly, Mosley and Hudson (1995, in Hudson & Mosley 2001:1025) found that aid had a tendency to reduce domestic savings. On the other hand, Dowling and Hiemenz (1982:12) observed that aid had a positive impact on savings, but their study was limited to the Asia region and was based on data only from the 1970s. Since Dowling and Hiemenz's study (1982) focused only on Asia, and used limited data, we can ignore their conclusion in the context of this study. Based on the evidence from the first phase (see section 3.2.1, table 3.1 and table 3.2), studies continued to find that foreign aid had no impact on domestic savings. The evidence of the impact of aid on investments, as we saw in section 3.2.1, table 3.1 and table 3.2, remained ambiguous.

Table 3. 2: Selected aid effectiveness studies 1975 to 1995

Selected aid effectiveness studies 1975 to 1995		
Authors	Year	Results
Heller	1975	Aid has positive impact on investments
Mosley	1980	Negative but insignificant impact of aid on economic growth
Papanek	1973	Aid has a significant and positive impact on growth
Dowling & Hiemenz	1982	Aid has a positive impact on growth, savings and investments (Asia region–1970s)
Gupta & Islam	1983	Aid has a significant positive impact on economic growth (only in Asia)
Singh	1985	Aid has a negative influence on domestic savings
Singh	1985	Aid has significant and positive impact on economic growth (but only if state intervention was not included in the analysis)
Cassen et al	1986	Project aid (micro) has a positive impact on growth (conclusion limited–project aid)
Mosley et al	1987	Aid has no impact on economic growth
Levy	1987	Aid had a significant and positive impact on economic growth (but only in SSA)
Levy	1987	Aid has a positive impact on investments (result limited to SSA)
Landau	1990	Project aid (micro) has a positive impact on growth (conclusion limited–project aid)
Killick	1991	Moderately positive impact of aid on growth, but results are fragile
Levine & Renelt	1992	Aid had a significant and positive impact on economic growth
Shan	1994	Aid has a negative impact on economic growth
Boone	1995	Aid had no significant impact on growth
Boone	1995	Aid has no impact on investment
Hadjimichael et al	1995	Aid has a significant and positive impact on growth but with diminishing returns
Mosley & Hudson	1995	Aid has a tendency to reduce domestic savings
Mosley & Hudson	1995	Aid had little impact on investment
Mosley & Hudson	1995	Aid has in aggregate a partial (small positive) impact on growth

In section 3.2.1 and table 3.1, we found that there was ambiguity over the impact of aid on investments, and this ambiguity continued in the second phase. For example, referring to table 3.2 above, we see that Mosley and Hudson (1995, in Hudson & Mosley 2001:1025) and Boone (1995:4) found that aid had little or no impact on investments. But Heller (1975:442) found that aid had a positive impact on investments. Two region-based studies, namely Dowling and Hiemenz (1982:12) and Levy (1988:1777), also found that a positive

relationship between aid and investments. Dowling and Hiemenz (1982) found that aid had a positive impact on investments, but their research was limited to the Asia region and only for the 1970s. Similarly Levy (1988:1777) found that aid had a positive impact on investments, but this result was limited to sub-Saharan Africa. It is difficult to draw a definite conclusion from this sample, since the evidence is varied. The latter studies of Dowling and Hiemenz (1982) and Levy (1988) are qualified by being restricted to specific regions, making it difficult to compare global analysis with region-specific analysis. (This important question of data samples will be addressed in section 3.6.5.) As we observed in the first phase in section 3.2.1 and table 3.1, and again in table 3.2, no clear conclusion can be drawn on the impact of foreign aid on investments. Fortunately studies focused on the aid-growth relationship in phase 2 were more numerous and the interpretation of results more indicative.

The studies on the relationship between aid and growth in table 3.2 can be divided into (1) those that found no impact on growth; (2) those that found a positive impact on growth; and (3) those that found a positive impact, but this positive result was qualified. Referring to the studies that found a negative impact (see table 3.2), Mosley (1980, in Durbarray et al 1998:3) found that aid had an insignificant impact on growth and later Mosley et al (1987:635) confirmed the earlier conclusion that aid had no impact on growth. Similarly, Shan (1994, in Clemens et al 2004:6) found that aid had a negative impact on growth and Boone (1995:4) found that aid had no significant impact on growth. Four studies therefore found that aid did not have any impact on growth (a negative result).

A number of studies in table 3.2 above showed a positive relationship between aid and growth, but the significance of the aid-growth relationship varied. For example, Papanek (1973:129) and Levine and Renelt (1992:962) found that aid had a significant and positive

impact on growth. Mosley and Hudson (1995, in Hudson and Mosley 2001:1025) found that aid had in aggregate a partial (small positive) impact on growth, while Killick (1991:1) found that aid had a moderately positive impact of aid on growth, but that the results of the study were fragile.²¹ Therefore four studies found that aid appeared to have some impact on growth, but the significance of the impact was varied and therefore unclear. In the next two paragraphs we will untangle the studies that found a positive relationship between aid and growth, but qualified their results. That is, the conclusions are not clear-cut. Three region-specific studies and two qualified studies are analysed (see table 3.2 above).

Three region-specific studies in table 3.2 found a positive relationship between aid and growth. The challenge with studies that focus on a specific region is that it is difficult to correlate the conclusions of these studies with studies that examined aid from a global perspective. For example, Dowling and Hiemenz (1982:11–12) found that aid had a positive impact on growth, but their study was limited to the Asian region, and was further bound to 1970s data. Gupta and Islam (1983, in McGillivray et al 2006:1036) found that aid in Asia had a significant positive impact on growth. Similarly, Levy (1988:1793) found that in sub-Saharan Africa, aid had a significant and positive impact on economic growth. From these two studies, we can conclude that foreign aid does have a positive impact on growth in Asia and sub-Saharan Africa, which are regions with a high number of aid-recipient countries. We therefore ignore the Dowling and Hiemenz (1982) study because its data was limited to the 1970s and the evidence was period and region bound. We ~~cautiously~~ accept the studies of Gupta and Islam (1983) and Levy (1987) as evidence, acknowledging that there does appear to be a positive impact on growth in two regions that encompass many aid-recipient countries. We therefore have two additional studies that find a positive relationship between aid and growth.

Two more studies in table 3.2 found that aid had a positive impact on growth, but their conclusions were qualified. Singh (1985:230) found that aid had significant and positive impacts on economic growth, but only if state intervention was not included in the analysis. If the results were qualified, as in the Singh (1985) study, this means that the econometric equations and data in a sense have been manipulated to return a positive result. This adjustment was indicated in the paper, so no malice was intended on the part of the researcher. (We address the important question of model design and specification in section 3.6.4 and data manipulation (inclusion/exclusion) in section 3.6.5.) In the context of this study, we again **cautiously** accept this as evidence that there does appear to be some positive relationship between aid and growth, but its significance is questionable. Similarly, Hadjimichael et al (1995, in Durbarry et al 1998:3) found that aid had a significant positive impact on growth, but their conclusion was also qualified, based on the question of diminishing returns. That is, after a certain level, too much aid becomes ineffective. Hadjimichael et al (1995) raised an important issue, that is, the question of what other variables could be influencing the impact of aid on growth and development. We will study the question of diminishing returns in more detail in section 4.2.4, but for this current discussion we accept their positive conclusion as evidence that aid does appear to have some positive impact on growth. The problem of qualified positive results becomes increasingly common in later research, and subsequently more difficult to interpret as evidence of the impact of aid on growth and development.

To summarise the above discussion and the information in table 3.2 above, we observe that four studies – namely Mosley (1980), Mosley et al (1987), Shan (1994) and Boone (1995) – found that aid had a negative impact on growth. Conversely four other studies – namely Papanek (1973), Killick (1991), Levine and Renelt (1992) and Mosley and Hudson (1995) – found that aid had a positive impact on growth, but that the positive relationship

between aid and growth was fragile. Furthermore, Gupta and Islam (1983) and Levy (1987) found that aid had a positive impact on growth in the regions they studied. Singh (1985) and Hadjimichael et al (1995) found that aid had a positive impact on growth, but their conclusions were qualified. We therefore **cautiously** conclude that aid does appear to have some positive impact on growth and development, but the magnitude of the impact is possibly small, and certainly the relationship between aid and growth is fragile.

We can add two pieces of evidence to this debate. The first is the argument raised in section 3.2.1 regarding the impact of aid on savings and investments. The second is evidence from a later study, undertaken by Hansen and Tarp (2000), which throws more light on the aid-growth relationship during this period. In section 3.2.1 we argued that if aid did not have a positive impact on savings and investments, then, based on the early growth models and economic theory (see section 2.2.2 and section 2.2.4), we concluded that this was evidence that aid did not have a positive effect on growth. Finally, there is the evidence from the Hansen and Tarp (2000) study that re-evaluated the second phase research. Hansen and Tarp (2000:112), analysing 72 regressions²² from the period 1975–1995, found that 1 regression indicated a negative aid-growth relationship; 40 showed that aid had a positive impact on growth; and 31 showed no impact on growth. Hansen and Tarp (2000:112) pointed out that of the ‘no impact regressions’, 12 were based on regressions that did not meet their minimum requirements, and thus could effectively be discounted. Hansen and Tarp (2000:114) therefore concluded from their analysis of the second phase studies that aid had a positive impact on growth.

Summarising the evidence from this phase, we therefore note that two studies found that aid did not have any impact on domestic savings and therefore, based on the above argument, we could state that this is further evidence of aid having a negative impact on growth. The evidence of the impact of aid on investments is inconclusive, so for the

analysis we ignore these studies. With respect to the aid-growth relationship, four studies found aid had a negative impact on growth; four found a positive impact; two region-based studies found a positive impact; and finally two qualified studies found a positive impact. Based on this evidence and the conclusion of the later Hansen and Tarp (2000) study, we can ~~cautiously~~ deduce that aid appears to have a small positive impact on growth, but the significance of this conclusion is fragile. As we noted in the first phase (see section 3.2.2), studies increasingly began to raise the question of other variables that could be influencing the impact of aid on growth and development.

3.3.2 EMERGING VARIABLES (1975 to 1995)

During the second phase, the number of new variables emerging from the research had grown significantly. Researchers grappling with ambiguous results or contradictions started to ask whether other variables might be influencing the impact of aid on growth and development. For example, donor aid allocation decisions, conditionality and motives affected the impact of aid. Similarly, the recipient's absorptive capacity could limit the recipient government's ability to use aid effectively, especially when aid was used for public consumption instead of investment. Other variables that emerged included aid fungibility, and the quality of state institutions and governance, all of which were found to influence the impact of aid on growth and development. The influence of these variables is discussed in more detail in chapters 4 and 5.

3.4 SUMMARY OF PHASES 1 AND 2 (1950 TO 1995)

The research so far has concluded that foreign aid did not have any impact on domestic savings (see discussions in section 3.2.1 and section 3.3.1). Furthermore, aid did not appear to have had any significant impact on investments in recipient countries, although this is not conclusive. If we refer back to modernisation theory (see section 2.2.1) and the

early growth models (see sections 2.2.2, 2.2.3 and 2.2.4) we can conclude that foreign aid did not fulfil its promise of filling the savings and investment gaps. Since aid did not fill the savings and investment gaps of the growth models, then according to the logic of the Harrod-Domar (see section 2.2.2 and 2.2.3) and two-gap models (see section 2.2.4), it can be argued that foreign aid did not fulfil the promise of modernisation theory and stimulate an economic take-off in recipient countries (see sections 2.2.1 and 2.2.4).

The literature is not clear on the impact of aid on growth either. The first phase (1950–1975) presumed, although with some ambiguity, that foreign aid had little or no impact on growth (see section 3.2.1). With regard to the second phase (1976–1995), we can ~~cautiously~~ conclude that foreign aid was having a slight positive impact on growth (see section 3.3.1). Many of the positive conclusions were fragile or were supported by qualifiers, which affected their reliability in the context of this study. We end the discussion in phases 1 and 2 by stating that, based on the evidence, it appears that aid had no impact on domestic savings; an inconclusive, if any, impact of recipient investments; and had only a small positive impact on growth and development, but the evidence for this conclusion is fragile.

While the question ‘Does aid work?’ remains largely unclear to this point, the research produced a number of positive side effects. Researchers began to consider other variables that could be influencing the impact of aid on growth and development. More importantly, the literature was forcing donors, governments and policymakers to question the modality of aid and to strive to improve the impact of aid on economic growth and development.

3.5 PHASE 3: AID, GROWTH AND POLICY (1996 to 2003)

In the phase 1 and 2 studies (1950–1995), research on the impact of foreign aid on growth and development provided ~~fragile-ambiguous~~ evidence and ~~a-cautious-conclusion~~ at best we can conclude that foreign aid appeared to have had a slight positive impact on growth and development. In the phase 3 and 4 periods, studies varied in their approach to measuring the impact of aid on growth and the number of studies increased exponentially, making analysis more complex. Studies varied in their approach to the way in which the impact of aid on growth and development should be measured, how data was assembled, and which methodology should be used by the researchers. The robustness of conclusions was dependent on model specification, sample size, time period and data composition. Furthermore, in the third phase the research became even more complex as researchers began to investigate other variables that were influencing the impact of aid on growth. Because of the complexity and large number of studies during the third and fourth phases, we will change our approach slightly and work on groups of studies around specific themes.

3.5.1 ANALYSIS OF THE IMPACT OF FOREIGN AID (1996 to 2003)

Studies on aid and the growth-policy relationship dominated the third phase. From the influential Burnside and Dollar (1997, 1998, 2000), studies, three main clusters of aid-policy studies evolved. First, the policy environment cluster supported the argument that the policy environment was critical to improving the impact of aid on growth and development. The most significant studies included Collier and Dehn (2001:33), Collier and Dollar (2001:1800), Lloyd, Morrissey and Osei (2001:24), Collier and Dollar (2002:1496), Chauvet and Guillaumont (2003:15), Dayton-Johnson and Hoddinott (2003:22),²³ Islam (2003:1468), McGillivray (2003:7),²⁴ all of whom found that the policy

environment was important if aid was to have a positive impact on growth. Second, the opposition concluded that aid had a positive impact on growth, irrespective of the policy environment. The most significant opposition studies included Durbarry et al (1998:17), Hansen and Tarp (2000:122), Lensink and White (2000:13), Dalgaard and Hansen (2001:37), Hansen and Tarp (2001:566), Hudson and Mosley (2001:1034), Lensink and White (2001:61), Lu and Ram (2001, in McGillivray 2006:1046), Morrissey (2001:38) and Gomanee et al (2003:15), who all found, to varying degrees, that aid had a positive impact on growth, irrespective of policy environment. The third cluster of studies found that the impact of aid on growth depended on variables beyond the policy variable. This third cluster of researchers began to study other variables and environments that could influence the impact of aid on growth. The emphasis in the literature had changed from studying aid efficacy to determining under what conditions aid could be more effective. These 'conditionality' papers began to incorporate the complexities of development, economic growth and the country environment.

Understanding the linkages between the various studies was becoming more complex as the study moved away from savings and investments to the more multifaceted study of growth and development. Table 3.3 below is a summary of 31 of the most commonly cited studies of the third phase period (1995–2003).²⁵ We begin with the studies that focused on the impact of aid on growth, where we find that 5 per cent²⁶ of the sample²⁷ found that aid had a zero or negative impact on growth, while 42 per cent²⁸ of the sample found that aid had a positive impact on growth (see table 3.3 below). The remainder of the sample found that aid had a positive impact on growth, but this was a qualified conclusion. That is, the conclusion depended on a third (or fourth) qualifying variable (see table 3.3 below).

Table 3. 3: Analysis of selected third phase studies (1996 to 2003)

Conclusion of the paper	Number	Percent
Aid has no impact on growth	2	3
Aid has positive impact on growth	27	42
Aid has negative impact on growth	1	2
Aid has a positive impact on growth but only in a good policy environment	9	14
Aid has a positive impact on growth irrespective of policy environment	10	15
Aid has a positive impact on growth and there are no diminishing returns	1	2
Aid has a positive impact on growth but with diminishing returns	7	11
Aid has a positive impact on growth and on welfare poverty	1	2
Aid has a positive impact on growth but more effective in countries experiencing shocks	3	5
Aid has a positive impact but is more effective in political, democratic stable countries	3	5
Aid has a positive impact on growth but climate & geography impact aid effectiveness	1	2
Total	65	100

The third phase studies appear to be more positive with respect to the impact of aid on growth and development. A quick scan of table 3.3 above shows a more positive picture, but is this a true impression? In section 3.3.1 we questioned the value of a qualified positive growth conclusion. If aid is found to have a positive impact on growth, BUT only if a certain variable is considered or included in the analysis (for example aid has a positive impact on growth only in a good policy environment), this is an example of a conditional variable. However, as we noted from this discussion and is apparent in table 3.3 above, the number of qualifying variables is increasing substantially, to the point that it becomes difficult to draw conclusions, since so many of the positive suppositions are qualified. For example, in table 3.3 above we see that 35 out of 65 studies found that aid had a positive impact on growth, but this conclusion was qualified. For example, Collier and Hoeffler

(2002:12), Ehrenpreis and Isenman (2003:12), and McGillivray (2003:7) all found that aid had a positive impact on growth, but that the impact of aid on growth was higher in countries experiencing shocks. Similarly, Svensson (1999:293), Kosack (2003:11) and McGillivray (2003:7) all found that aid had a positive impact on growth, but was more effective in democratic, politically stable countries. Finally, Guillaumont and Chauvet (2001:87) found that aid had a positive impact on growth, but was dependent on the climate and geography of the recipient country. Referring back to these studies, this implies that aid will be most effective in politically stable, democratic countries in the right geographical location with a perfect climate. Obviously this conclusion is absurd, but it does indicate the magnitude of the problem one faces when trying to discern whether aid is having an impact on growth. But this is not the only problem with research during this period. There is a significant level of contradiction within the literature itself.

During the third phase, studies began to explore other variables that could influence the impact of aid on growth and development. Once researchers included other variables in their studies, the contradictions and ambiguity increased, making it even more difficult to discern the impact of aid on growth and development. For example, nine studies²⁹ found that aid had a positive impact on growth, but only in a positive policy environment, whereas ten studies³⁰ found that aid had a positive impact on growth, irrespective of the policy environment. Therefore we find that there is no conclusive evidence to support the influential Burnside and Dollar conclusion (see section 2.5.2) that aid only works in a good policy environment. Similarly, when we examine the question of diminishing returns, we find that seven studies³¹ found that aid was subject to diminishing returns. That is, the more aid a country received, the less impact aid had on growth and development. Conversely, one study³² found that aid was not subject to diminishing returns.³³ A further eight studies found that aid had a positive impact on growth, but that this was conditional

on a third variable, such as external shock, climate, geography, and level of democracy. The increasing number of variables demonstrates that aid does not function in a vacuum, and that there are factors and complex relationships that influence aid, growth and development. It is increasingly difficult to draw conclusions from the literature when the studies become more varied and complex, but this complexity does lead us to question the methodology and rationale of measuring the impact of aid against growth in the recipient countries.

If aid functions in a complex environment, and if all the variables mentioned in this section and previous sections (see section 3.2.2 and 3.3.2) are valid, then one could argue that every variable is important when measuring the impact of aid on growth. If diminishing returns, policy environment, climate, geography, and political stability are important variables, then logically no analysis of the impact of aid on growth is complete without considering all of them. Therefore, any researcher wishing to measure the impact of aid on growth must develop a model and analysis that incorporate all the variables. The problem is that even the variables are subject to dispute. For example, nine studies found the policy environment was important, and ten studies found that the policy environment was irrelevant. If the research is so controversial, how can researchers discern whether policy environment is a crucial variable or not? We will address this important question of measurement and methodology in sections 3.6.3 to 3.6.6.

During this period, the consensus in the literature appeared to indicate that aid had a slight positive impact on growth and development. However, and more importantly, it was clear from the literature that aid does not operate in a vacuum. Numerous variables influence a developing country's ability to grow and develop. Growth and development are complex processes, dependent on complex dynamics between multiple variables. Therefore, to

understand the impact of aid on growth and development, it is important to comprehend the influence other variables may have on the foreign aid. The impact of the variables is considered in more detail in chapters 4 and 5.

3.5.2 MORE EMERGING VARIABLES (1996 to 2003)

A number of new variables emerged during this phase, but the most important theme was how the policy environment influenced the effectiveness of aid. The main variables that emerged during the third phase included diminishing returns; aid volatility and unpredictability that made investment uncertain; aid fungibility; the impact of aid on poverty reduction (including welfare); influence of external shocks (economic and natural disasters); levels of democracy; and the influence of geography and climate. Besides these, a number of new variables began to emerge. These included the influence of aid flows in the recipient countries; governance and state institutions; and the methodology used to measure the impact of aid. Growth and development are intricate processes, dependent on the complex interaction of multiple variables. Foreign aid is given to recipient countries, each of which has its own unique characteristics and environments that are not easily measured by the current methodology. In chapters 4 and 5 the variables are grouped into related clusters in order to gain a better understanding of how these variable clusters influence the effectiveness of foreign aid and what measures could be taken to improve the impact of foreign aid on growth and development.

3.6 PHASE 4: AID, GROWTH AND METHODOLOGY (2004 to 2010)

In the fourth phase (2004–2010),³⁴ researchers returned to the favoured question of whether aid was having an impact on growth and development, although they maintained an interest in the aid-growth-policy relationship. Researchers continued to study the influence of other variables that might be affecting the ability of aid to have a positive

impact on growth and development. But perhaps the most important focus during this period was the number of studies that began to question the value of cross-country regression analysis as a methodology for measuring the impact of foreign aid.

3.6.1 ANALYSIS OF THE IMPACT OF FOREIGN AID (2004 to 2010)

The trend of studying the role of other variables continued from the third into the fourth phase. But there was renewed interest in the question of whether aid was having a positive impact on growth. From a sample of 36 conclusions (see table 3.4 below) 6 studies found that aid had no impact on growth;³⁵ 1 study³⁶ found that aid had a negative impact on growth; and 13 studies³⁷ found that aid had a positive impact on growth. Therefore there were 7 no impact or negative impact conclusions, compared with 13 positive conclusions – hardly conclusive evidence that aid was having any significant and positive impact on growth and development, but an indication that aid may have some positive impact on growth.

Further evidence is found in 16 studies (see table 3.4 above) that aid had a positive impact on growth, but these conclusions were qualified. For example, Burnside and Dollar (2004:19) and Collier and Dollar (2004:255) found that aid had a positive impact on growth, but only in a good policy environment. Conversely five studies – namely Dalgaard, Hansen and Tarp (2004:212); Easterly, Levine and Roodman (2004:775); Gomanee et al (2005:308); Islam (2005:1468) and Outtara and Strobl (2005:4) – found that aid had a positive impact on growth, irrespective of the policy environment. Changing direction, Dalgaard et al (2004:212) found that aid had positive impact on growth, but with diminishing returns.

Table 3. 4: Selected fourth generation studies

Conclusion of the paper	Number	Percent
Aid has no impact on growth	6	17
Aid has positive impact on growth	13	36
Aid has negative impact on growth	1	3
Aid has a positive impact on growth but only in a good policy environment	2	6
Aid has a positive impact on growth irrespective of policy environment	5	14
Aid has a positive impact on growth and there is no diminishing returns	0	0
Aid has a positive impact on growth but with diminishing returns	1	3
Aid has a positive impact on growth and on welfare poverty	4	11
Aid has a positive impact on growth but more effective in countries experiencing shocks	1	3
Aid has a positive impact on growth but more in political, democratic stable countries	1	3
Aid has a positive impact on growth but climate and geography impact aid effectiveness	2	6
Total	36	100

Heady, Rao and Duhs (2004:3) found that aid was more effective when the recipient had experienced a shock. Islam (2005:1468) found that aid was effective, but only in political stable environment. Taking a different approach, Heady et al (2004:3) and Dalgaard et al (2004:212) found that geographic location had an influence on the impact of aid on growth.

In a very general analysis of table 3.4 above, ~~and drawing only a cautious generalised conclusion,~~ we deduce, based on 13 positive and 16 positive but conditional studies, that aid has some positive impact on growth, but the magnitude of the impact is probably only small. There is still no definitive answer to the important question 'Does aid have a positive impact on growth and development?' However, ~~a cautious conclusion~~ from the research in the fourth period ~~is that~~ aid appeared to have some positive impact on growth, but the magnitude of the impact was dependent on an increasing number of variables, and was

therefore much harder to determine. The increasing number of variables led researchers to question the value of cross-country regression analysis as a methodology for measuring the impact of aid on growth and development. From an analysis of more than 50 years of research, one can question the value of cross-country regression analysis as a tool for measuring the impact of aid on growth and development. The current methodology can be probed, based on two arguments. First, the value of the methodology used to measure the impact of foreign aid is questionable, since it produces ambiguous results. Second, based on the number of variables that researchers have proved to influence the impact that aid can have on growth, the use of economic growth as an indicator to measure the impact of aid is questionable.

During the third and fourth phases, the methodological question became increasingly important. A number of scholars have recently expressed dissatisfaction with the use of cross-country regression analysis as a tool for measuring the impact of aid on growth and development. The current methodology (cross-country regression analysis) is queried in terms of model construction, data construction and sampling procedures. The disadvantage of the current methodology is that the positive impact in one country (or several countries) can cancel the negative impact of another country(ies), therefore producing a result that is not necessarily reflective of the impact of foreign aid on growth. The methodology is a generalisation of the impact of foreign aid across a large number of countries, which tends to average out data differences among countries. In the next four sections, we will discuss the methodology used to evaluate the impact of foreign aid on growth and development. This discussion on methodology is important because since the mid 1990s it has become increasingly difficult to determine the impact of aid on growth and development.

3.6.2 CROSS-COUNTRY REGRESSION ANALYSIS EXPLAINED

Cross-country regression analysis is a statistical econometric methodology that is used to measure the effectiveness of foreign aid. Conducting a cross-country regression means assembling large samples of data from a multitude of countries (sometimes up to 137 countries), all at various stages of development, and then statistically calculating whether foreign aid, on the whole, has had an impact on growth and development. This form of analysis treats all countries, aid types and periods as homogeneous units, which they certainly are not. The simplest form of a regression is a linear, bivariate regression, which describes the relationship between two phenomena such as foreign aid and growth. The data, in the context of this study, would be aid given to recipient countries and economic growth in recipient countries. Researchers then determine the relationship between aid given and growth in the recipient country. The data could be plotted on a graph and will typically be scattered on the graph. The regression analysis creates the single line on the graph that best summarises the distribution of the points. The regression analysis determines the correlation between aid and growth but does not explain the causation. Regression analysis alone cannot answer the question of aid's impact on growth and development. It still needs critical thinking and careful study to determine the impact of foreign aid on growth. Regression analysis at best can only establish the existence of connections between aid and growth. Dalgaard and Hansen (2009:3) point out that 'regression analysis cannot answer the question if foreign aid is effective in the sense that it increases the growth of GDP per capita'. Dalgaard and Hansen (2009:3) call for the application of a more advanced regression techniques, which as they point out will require 'quantitative information, which is in practise very difficult to obtain'. And even if more advanced regression techniques are possible it is unreasonable to assume that aid works equally in every country. The results from regression analysis of aid effectiveness are according the Dalgaard and Hansen (2009:3) likely to be misleading. Rajan and

Subramanian (2008:647) point out that cross-country regression analysis has serious problems, including the question of endogeneity; the handling of outliers;³⁸ measurement error; data selection decisions; and data noise.³⁹ These problems collectively create sufficient uncertainty to question the methodology. Besides these problems, there is the fundamental issue of dealing with omitted variables and, as we have seen in this chapter, many variables influence aid and growth. We argued in section 3.5.1 that if the variables that researchers were including in their calculations are important, then each variable should be incorporated in the model used to determine the impact of aid on growth. But including variables is not the only problem. There is still the issue of measuring variables consistently and accurately across multiple countries over long periods. When a researcher uses a large data sample over long periods (in some cases up to 50 years), the data is plagued with irregularities, making any strong claims about the impact of aid questionable, since the models (and calculations) are based on unreliable or incomplete data (Rajan & Subramanian 2005:5). In cross-country regression analysis, researchers can never be certain that they have considered all the possible ways in which countries differ in their use of foreign aid, making the use of this methodology dubious.

3.6.3 QUESTIONING THE USE OF CROSS-COUNTRY REGRESSION

Since the early 1950s, researchers have been calculating the impact of foreign aid on growth. The subsequent debate in the literature has produced literally hundreds of research papers, but in the final analysis, the conclusions are ambiguous and subject to debate and controversy. At best, the literature can provide only a general indication that foreign aid appears to have a slight positive impact on growth. Foreign aid, economic growth and development are multifaceted concepts that are influenced by many variables in intricate relationships. Measuring the impact of aid on growth is equally complex. A

small but growing number of researchers are questioning the value of the cross-country regression analysis as the most appropriate methodology for measuring the impact of aid on growth. Doucouliagos and Paldam (2006:2) reflected on 'the sad result of 40 years of research' and questioned the value of cross-country regression analysis. Similarly, Cassen et al (1986, in Riddle 2007:234) inferred that cross-country analysis provided no conclusive evidence about the impact of aid, and that the best source of information would be a methodology other than cross-country regression analysis. Furthermore Duflo and Kremer (in Riddle 2007:24) argued that the contribution of aid to growth, development and poverty reduction cannot be ascertained by trying to establish a cross-country relationship between recipient countries and foreign aid, and that such conclusions are nothing more than 'red herrings', distracting researchers and decision makers from the real issues of foreign aid. Quibria (2004:17) argued that in light of the inadequacies of cross-country methodology and data disputes, regression analysis should be abandoned in favour of an alternative, such as country-specific case studies. Stern, former chief economist of the World Bank, publicly acknowledged that cross-country regressions and the evaluation of the impact of aid were not producing concrete evidence that could influence policy or strategy. Stern (2005:1) commented, 'One cannot really disentangle with any confidence the direction of causation between aid and growth or between aid and poverty.' Riddle (2007:224) appealed for a discontinuation of the huge volume of cross-country analysis and suggested that researchers seek out a more conclusive and robust methodology for evaluating the effectiveness of foreign aid. The discussion in this chapter supports this researcher's arguments and reinforces our argument that cross-country regression analysis is providing, at best, a general indication of the impact of aid on growth and that an alternative method should be found to determine the impact of aid on growth and development.

In the next three sections, we will substantiate our argument that cross-country regression analysis is not a suitable methodology for measuring the impact of aid on growth and development.

3.6.4 PROBLEMS WITH MODEL DESIGN AND SPECIFICATION

Theory does not provide adequate guidance as to which models or variables should be selected when measuring the impact of aid on growth. Researchers evaluating the impact of foreign aid are faced with a number of challenges. First, there is inadequate theory; second, incomplete and unreliable data (especially older data); third, an insurmountable number of variables that influence the impact of aid on growth and development; and fourth, the challenge of deciding which variables to include/exclude in the statistical model. Dalgaard and Hansen (2009:3) argued that 'basic regression analysis cannot answer the question if foreign aid is effective in the sense that it increases the growth of GNP per capita'. More advanced regression techniques are required to achieve an understanding of the impact of aid on growth. But even the use of advanced regression analysis will not really solve the problem, since the analysis still requires reliable and valid quantitative data, which in practice is very difficult to obtain (Dalgaard & Hansen 2009:3). There are a number of reasons that macro economic indicators and cross-country analysis have not been productive in evaluating the impact of aid on growth or development. First, statistical relationships between aggregates do not tell us whether the causality between the variables or the observed relationships is owing to external factors or because of the interrelationships between aid and other variables. Statistical relationships 'at best capture and summarise relationships in the data' and do not necessarily capture the 'real' relationships between aid, growth or development (Riddle 2007:224). Second, drawing conclusions at country level is difficult enough, but at cross-country level, conclusions are dubious (Riddle 2007:224). Finally, determining which variables to include in the statistical

model is complex and fraught with danger. But model design and specification is not the only challenge. Even if a researcher could design the perfect model, the data used by the research is riddled with problems

3.6.5 DATA SELECTION AND MANIPULATION

In any research study, the calculations and conclusions are only as reliable as the data used in the calculations. Researchers wishing to measure the impact of foreign aid on growth need to solve a number of problems when choosing their samples and developing their datasets. The problems include (1) incomplete and unreliable data; (2) the selection of the sample; (3) noise in the data; (4) pooling data; and (5) not disaggregating the data. First, country data from the 1950s, even to the 1980s, is unreliable and often incomplete for many aid-recipient countries. During the early development years, data collection was not a top priority, and organisations such as UNDP did not gather detailed economic growth and development data. Even today in a number of fragile or conflict states that are recipients of foreign aid, the datasets from these countries are unreliable. Second, the construction of the data sample has an impact on the reliability and validity of the research results. The selection of the sample and the sample period can have a significant influence on the results of an analysis. For example, the Burnside and Dollar (1997, 1998, 2000) studies have been refuted by Easterly (2003), Jensen and Paldam (2003) and Easterly, Kremer, Pritchett and Summers (2004), who found that the policy environment was no longer valid if more countries or a further four years of data were added to the Burnside and Dollar sample. Third, datasets from recipient countries may be filled with data noise. Rajan and Subramanian (2008:649) pointed out that if the data used in cross-country regression analysis was plagued by noise, then strong claims about the impact of aid on growth were unjustified. Fourth, pooling data across countries is problematic, since it is assumed that all country data is homogeneous. In other words, data pooling presumes

that the productivity of aid is constant across all countries in the sample. Obviously, aid productivity will vary from country to country and even across time periods within the same country. Finally, the data should be desegregated between types of aid and between the short- and long-term impacts of aid. Lensink and White (2000:7) pointed out that aid had many facets, including humanitarian aid, technical assistance, debt relief, project aid, direct budget support and sectoral programme aid, all of which impacted on growth differently over differing time periods. Data reliability, validity, sample selection, noise in the data and the use of pooled, unsegregated data across multiple countries add further reservations to the use of the current methodology for measuring the impact of foreign aid. If the samples and the data are problems, then we argue that the continued use of cross-country regression analysis for determining the impact of aid on growth is questionable. But can one even continue to rely on cross-country regression analysis as a tool for the measurement of the impact of aid on growth and development? The next section will address this important question.

3.6.6 LIMITATIONS OF CROSS-COUNTRY REGRESSION ANALYSIS

Because the aid effectiveness debate is inconclusive, producing controversial, fragile results, this indicates the limitations of cross-country analysis as a tool for measuring aid effectiveness. There are five limitations in the use of cross-country analysis. First, Bourguignon and Leipziger (2006:4) stated that there was the problem of reverse causality. That is, figuring out the direction of causation is the challenge. (Which is the cause? Which is the effect?).. For example, aid can promote growth, but in the event of an economic shock, there will be a decline in growth. The negative impact of the shock causes an increase in aid flows as donors respond to the shock and a decline in growth rates. This is the problem of aid endogeneity. Researchers have recently tried to control aid endogeneity, but the instruments used to control it are themselves contentious.

Second, countries are not homogeneous, and each recipient country has unique characteristics, culture and environment. Cross-country regressions ignore country-specific data. For example, if Sierra Leone is included in the regression analysis, and the study period includes the civil war years, Sierra Leone shows up as a low-growth country. Angola has high growth rates, but this growth is related to oil, and not aid. In Mozambique, aluminium dominates the export profile, constituting 61 per cent of Mozambique's exports in 2005. Fuel constitutes roughly 40 per cent of Mozambique's import bill (DFID 2008:15). Cross-country regressions often ignore these characteristics, which are typical of low-income economies. Much of the research on growth is not based on comparative data, and therefore does not address specific issues such as structural change, shocks or dualism in the economy.

Third, donors supply aid for a number of reasons besides economic growth and development, as we have seen. Foreign aid is provided for political, strategic and economic motives linked to the donor's own economy and strategic security. Donors even offer aid to fight drug trafficking and international crime (Riddle 2007:141). Large flows of humanitarian aid such as the 2004 Tsunami are aimed specifically at relief and not growth (McKinlay & Little 1979:234). Aid to Egypt and Israel is strategic and devoted to supporting the Middle East Peace process, and is not focused primarily on promoting growth in the region (Ram 2003:97). If donors provide aid to recipient countries for reasons other than promoting growth, it is unreasonable to measure the impact of aid by using growth as the indicator.

Fourth, the impacts of various types of aid are not the same and these are seldom differentiated in the analysis. Aid has short- and long-term impacts. Long-term aid includes

infrastructure investments, and aid to productive sectors of the economy – for example private sector and agriculture, budget and balance of payments support. Aid allocated for poverty reduction – for example health, water, and education – is unlikely to have an impact on growth in a four-year period. According to Clemens et al (2004:37), disaggregating aid flows into short- and long-term aid may improve the quality of aid effectiveness analysis.

Finally, identifying causal mechanisms is a complex process. Cross-country growth analysis and the early growth models (see sections 2.2.2, 2.2.3 and 2.2.4) assumed that domestic savings and productive investments were the main drivers of growth. But not all aid is used for domestic savings or productive investment. For example, when aid is used for public consumption (for example improving public service delivery such as health, water and education), the result is poverty reduction, with little if any growth- or productivity-related outputs that the researcher can use in the analysis. Similarly, when donors provide technical assistance, it is difficult to measure it and incorporate it into the regression analysis. In these two examples it is difficult for the researcher to know whether aid caused growth, since the impact of aid in both of them is indirect and long term. In the regression analysis, there is an assumption that all forms of aid contribute to growth, but this is not necessarily the case. These five factors of regression analysis raise doubts as to the suitability of cross-country regression analysis as a tool for measuring the effectiveness of foreign aid.

There must be a better way to evaluate and measure the effectiveness of foreign aid beyond the endless stream of ambiguous cross-country regression analysis. Research and empirical conclusions on aid effectiveness based on cross-country regression analysis depend on critical methodology choices and poorly understood non-linearities. Roodman

(2007:18), however, suggested that cross-country regressions might have reached the limits of their ability to reveal how effective aid is in impacting on growth. Cross-country regressions, according to Roodman (2007:18), must be supplemented with other methods of analysis. For example, country case assessments and project evaluations may have a significant future role to play in assessing aid effectiveness. According to Bourguignon and Leipziger (2006:6), evidence from specific programmes and country case studies may provide a better understanding of aid effectiveness. But even if researchers figure out a better methodology for measuring the impact of foreign aid on growth, there is still the question as to why the impact of aid is measured against the indicators of economic growth? This question will be addressed in chapter 4. In the next section we consider the feasibility of a country case study as an alternative method for measuring the impact of foreign aid on growth.

3.6.7 COUNTRY CASE STUDY AS A POSSIBLE ALTERNATIVE

A number of arguments support the rationale of using a country-specific case study to measure the impact of aid on growth. Case studies, rather than using data from multiple countries and over long periods, evaluate the impact of foreign aid based on the data of that specific country. The case study analysis is therefore more focused and not subject to the complexities of using data from more than 100 countries. Furthermore, case study analysis allows the researcher to focus on the specific characteristics of the country under evaluation. For example, Feeny (2005:1092) in an analysis of growth in Papua New Guinea, found little evidence that aid had any positive impact on growth in that country. Conversely, Al-Khaldi (2008:16) found that in Jordan foreign aid did have a positive impact on growth. These two opposite conclusions are important since they are country specific. Furthermore, case studies have the advantage that they can take into consideration the particular characteristics and environment of individual countries, rather than treating all

countries, aid and donors as homogenous groups that act in uniform ways. Perhaps country-specific case studies offer better insight into the impact of aid on growth and development.

A number of arguments support the rationale of using a country-specific case study to measure the impact of aid on growth. Case studies, rather than using data from multiple countries and over long periods, evaluate the impact of foreign aid based on the data of that specific country. The case study analysis is therefore more focused, and not subject to the complexities of using data from more than 100 countries. In addition, case study analysis allows the researcher to focus on the specific characteristics of the country under evaluation. Next, case studies have the advantage that they can take into consideration the particular characteristics and environment of individual countries rather than treating all countries, aid and donors as homogenous groups that act in uniform ways. Finally in a country-specific case study the researcher will be able to disaggregate foreign aid into at least two categories: (1) aid for growth; and (2) aid for public consumption (welfare). In this way it may be possible to measure the impact of foreign aid against economic growth and welfare indicators.

3.7 CONCLUSION OF THE LITERATURE ANALYSIS

In this chapter we found that, despite substantial investment, foreign aid has not produced the anticipated results in terms of growth, or development. After nearly 50 years of research there is still no conclusive evidence on the impact of foreign aid on savings, investments, growth and development in recipient countries. We saw from our discussion in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) that foreign aid does not have any impact on domestic savings. Furthermore, in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) we found that foreign aid did not appear to have had any

significant impact on investments in recipient countries, although this is not conclusive. If we refer back to modernisation theory (see section 2.2.1) and the early growth models (see sections 2.2.2, 2.2.3 and 2.2.4) we can conclude that foreign aid did not fulfil its objective of filling either the savings or the investment gap. Since aid did not fill these gaps, based on the logic of the Harrod-Domar (in section 2.2.2) and two-gap models (in section 2.2.4), we argue that foreign aid did not fulfil the promise of modernisation theory and stimulate the economic take-off in recipient countries (see section 2.2.1 and section 2.2.4).

The literature is ambiguous about the impact of foreign aid on growth, but we can ~~cautiously~~ deduce that aid does appear to have a slight positive impact on growth. The first phase research (1950–1975) concluded, although with some ambiguity, that foreign aid had little or no impact on growth (see section 3.2.1). The second phase (1976–1995) was slightly more optimistic (see section 3.3.1) and found that foreign aid appeared to have a slight positive impact on growth. The third phase (1996–2003) supported the second phase observation that foreign aid has a slight positive impact on growth and development (see section 3.5.1). However, this positive conclusion was backed by little robust evidence. The fourth phase (2004–2010) continued to support the slight positive aid-growth conclusion (see section 3.6.1). But the magnitude of the impact is dependent on a number of variables and therefore much harder to determine. Therefore, based on the evidence of more than 50 years of research, we conclude that foreign aid has no impact on domestic savings, no impact on recipient investments, and only a slight positive impact on growth and development. Nevertheless, the evidence for this positive aid-growth conclusion is fragile. The research, however, had produced a number of positive side effects.

Researchers, in their attempts to determine the impact of aid on growth, began to consider other variables that might be influencing the impact of aid on growth and development. The literature has revealed a number of important variables that can be grouped into four categories of donors variables; impact of aid on recipient country; recipient environment and actions; and external factors. The variables are important for two reasons. First, they indicate how complex and 'messy' development really is. Second, they demonstrate that many variables, apart from foreign aid, influence a country's development. Therefore trying to attribute a country's growth solely to the provision of foreign aid is questionable. If aid is not the only variable influencing a country's growth, then measuring the impact of aid against the indicator of growth is also questionable.

The increasing number of variables has led to a questioning of the value of cross-country regression analysis as a methodology for measuring the impact of aid on growth and development. From our analysis, we also question its value as a tool for measuring the impact of aid on growth and development. Cross-country regression analysis is questioned in terms of econometric formulae construction, data construction and sampling procedures. The methodology is a generalisation of the impact of foreign aid across a large number of countries, which tends to average out data differences between countries. Cross-country regressions must therefore be supplemented with other methods of analysis or replaced by a more appropriate methodology. Evidence from specific programme and country case studies may provide a better understanding of the impact of foreign aid on growth and development. But even if researchers figure out a better methodology for measuring the impact of foreign aid on growth, there is still the important question of why we measure the impact of foreign aid against the indicators of economic growth? In chapters 4 and 5 we will discuss the impact that the variables have on foreign aid and

determine the viability of measuring the effectiveness of foreign aid against the indicator of economic growth.

NOTES

¹ The Burnside and Dollar paper was developed over a number of years. It first circulated in 1997 and 1998 as a World Bank Policy Research Working Paper. The paper was also cited in the World Bank 1998 Report 'Assessing Aid'. In 2000 the paper was published in the influential *American Economic Review*. From this point onwards I will only refer to the paper as Burnside and Dollar (2000) for simplicity. In essence Burnside and Dollar (1997), (1998) and (2000) papers are all the same.

² Aid is fungible when it replaces expenditure that the recipient would otherwise have undertaken

³ This is referred to as 'aid fungibility'. Governments replace own income with aid and then use the freed-up income to fund non-productive or wasteful expenditure, for example military,

⁴ Domar was one of the founders of the Domar-Harrod growth model, and Rostow was a key influence in modernisation theory. Both researchers argued that aid could be used to promote economic growth, but their arguments came at the birth of aid, and there were no data or studies to contradict their assumptions. See section 2.2.2.

⁵ Durbarry et al (1998:3) noted that the Griffin (1970) and Griffin and Enos (1970) studies used the current account deficit to support their conclusions that aid was having a negative effect on growth

⁶ Weisskopf's (1972) conclusion of aid having no impact on savings implied that aid had no impact on growth, according to the gap models, since aid was to fill the savings gap and therefore stimulate growth. If aid did not fill the savings gap, then aid would not contribute to growth, So for the aid/growth relationship we can conclude that Weisskopf (1972) found that aid had no impact on growth.

⁷ Rahman (1968), Griffin (1970), Griffin and Enos (1970), Bauer (1972) and Weisskopf (1972) all concluded that aid had a negative impact on savings, investments and growth.

⁸ Exceptions to the negative conclusion include Domar (1947), Rostow (1956) and Papanek (1973). Domar and Rostow's conclusions came early in the foreign aid lifespan, and could be excluded, based on insufficient data, making the Papanek 1973 conclusion the only contradictory conclusion from the early studies.

⁹ The sample of papers for this study was drawn from the most commonly cited studies in the aid effectiveness literature. My analysis is based on the conclusions of other studies and I have not done any regression calculations as this is outside my field of study. Citations and conclusions, however, were cross-checked using different sources and sorted using an access database. The conclusions database has more than 1 200 conclusions from over 200 research studies on aid effectiveness. This study is not in econometrics, so I have not attempted to do any regression analysis, as Hansen and Tarp (2000) have done, but have relied on the observations and conclusion from others research. The annexure, however, shows that the evidence is inclined towards the aid having no or a negative impact for both savings and growth. However, I do respect the work of Hansen and Tarp and have therefore cited their conclusions, but have also cited those of White (1992) and McGillivray et al (2006), who concluded that the early evidence was inconclusive or negative.

¹⁰ Griffin (1970), Griffin and Enos (1970) and Viovodas (1973).

¹¹ Friedman (1958) and Bauer (1972).

¹² Domar (1947), Rostow (1956) and Papanek (1973).

¹³ Rahman (1968), Griffin (1970) and Weisskopf (1972).

¹⁴ Griffin and Enos (1970) and Gupta (1970).

¹⁵ See sections 2.2.2 and 2.2.3.

¹⁶ The question of consumption continued to rear itself regularly. Consumption is addressed in section 5.2.3.

¹⁷ For a more detailed econometric discussion of second generation models, see Hansen and Tarp (2000:110 to 114).

¹⁸ 'In a reduced form regression, an endogenous variable is expressed as a function of predetermined variables (purely exogenous or lagged endogenous) and the error term. A reduced form regression can be consistently estimated by ordinary least squares (OLS). It is also used to find out whether an equation in a system of simultaneous equations is identified' (Lund University 2011:1)

¹⁹ This study is not an attempt to analyse the econometrics of the aid effectiveness debate. Econometrics belongs to the field of economics and not development studies. This study relies on the conclusions drawn by the researchers (all of whom are economists) and who all present convincing arguments as to why their research, data, models, equations and analysis are correct and why others before them have failed. The following papers present an excellent discussion on the econometric models and formulas used in measuring aid effectiveness: White (1992), Hansen and Tarp (2000), Clemens et al (2004), McGillivray et al (2006), Rajan and Subramanian (2008), Dalgaard and Hansen (2009) Dalgaard and Hansen (2010). These papers all present detailed econometric explanations of the underlying economic models, data sets, regression analysis and equations used in measuring aid effectiveness.

²⁰ All studies cited in this section are referenced in the text, and additionally the studies are all summarised and referenced in the annexure.

²¹ A fragile relationship means that the conclusion is not robust.

²² A regression is a calculation used in the study of the impact of aid on growth. In Hansen and Tarp's analysis, they used the regressions from all of the major studies of the period, so we can accept their conclusions as evidence. Hansen and Tarp are respected economists in the development economic debate.

²³ But only in sub-Saharan Africa.

²⁴ McGillivray includes a number of conditions to aid's effectiveness besides the policy condition

²⁵ Please refer to the annexure for more details of the analysis and how these conclusions were drawn from the literature.

²⁶ Boone (1996:27); Guillaumont and Chauvet (1999:87).

²⁷ From a sample of 31 papers there were 65 conclusions. Please refer to annexure 4 for a detailed view of how this analysis was done. Most papers drew more than one conclusion in their research. In table 3.3 above, the total 65 refers to the number of conclusions, and not the number of papers (which was 31).

²⁸ Amavilah (1998:694); Durbarry et al (1998:17); Lensink and Morrissey (1999:22); Svensson (1999:293); Burnside and Dollar (2000:847); Hansen and Tarp (2000:122); Lensink and Morrissey (2000:45); Lensink and White (2000:13); Collier and Dehn (2001:33); Collier and Dollar (2001:1800); Dalgaard and Hansen (2001:37); Gounder (2001:1009); Hansen and Tarp (2001:566); Hudson and Mosley (2001:1034); Lensink and White (2001:61); Lloyd et al (2001:24); Lu and Ram (2001 in McGillivray 2006:1046); Morrissey (2001:38); Collier and Dollar (2002:1496); Collier and Hoeffler (2002:12); Chauvet and Guillaumont

(2003:15); Dayton-Johnson and Hoddinott (2003:22); Dayton-Johnson and Hoddinott (2003:23); Ehrenpreis and Isenman (2003:12); Gomanee et al (2003:15); Islam (2003); Kosack (2003:11) and McGillivray (2003:7).

²⁹ Burnside and Dollar (2000:847); Collier and Dehn (2001:33); Collier and Dollar (2001:1800); Lloyd et al (2001:24); Collier and Dollar (2002:1496); Chauvet and Guillaumont (2003:15); Dayton-Johnson and Hoddinott (2003:22-23); Islam (2003); and McGillivray (2003:7).

³⁰ Durbarry et al (1998:17); Hansen and Tarp (2000:122); Lensink and White (2000:13); Dalgaard and Hansen (2001:37); Hansen and Tarp (2001:566); Hudson and Mosley (2001:1034); Lensink and White (2001:61); Lu and Ram (2001 in McGillivray 2006:1046); Morrissey (2001:38); Gomanee et al (2003:15);

³¹ Durbarry et al (1998:17); Dalgaard and Hansen (2001:37); Hansen and Tarp (2001:566); Hudson and Mosley (2001:1034); Lensink and White (2001:61); Lu and Ram (2001, in McGillivray 2006:1046) and McGillivray (2003:7).

³² Gomanee et al (2003:15).

³³ Seven papers found that aid was subject to diminishing returns and one paper found that diminishing returns were irrelevant. Diminishing returns will be covered separately in this study, since it is an important aspect in the aid effectiveness debate.

³⁴ All studies cited in this section are referenced in the text and additionally the studies are all summarised and referenced in the annexure.

³⁵ Feeny (2005:1092); Rajan and Subramanian (2005b:2); Burke, Fredoun, and Esfahani (2006:350); Doucauliagos and Paldam (2006:26); Rajan and Subramanian (2008:643) and Dalgaard and Hansen (2010:3).

³⁶ Mallik (2008:251).

³⁷ Burnside and Dollar (2004:19); Clemens et al (2004:37); Collier and Dollar (2004:255); Dalgaard et al (2004:212); Easterly et al (2004:775); Economides et al (2004:17); Heady et al (2004:3); Gomanee et al (2005:355); Islam (2005:1468); McGillivray (2005:2); Ouattara and Strobl (2005:4); Al-Khaldi (2008:16); and Dalgaard and Erickson (2009:1178).

³⁸ An outlier is something that is detached or far removed from the main body of evidence.

³⁹ Data noise is when the data contains large or random fluctuations that distract or interfere with the results.

CHAPTER 4: DONOR AND AID VARIABLES

4.1 INTRODUCTION

Foreign aid does not function in a vacuum, and donors and recipients have specific characteristics, environment, needs, and motives for engaging with the aid system. The aid literature, as discussed in chapter 3, has uncovered a number of important variables that influence the impact of foreign aid on growth and development. These variables can be grouped into four categories, namely (1) donor variables; (2) aid variables; (3) recipient environment and actions; and (4) external factors. In this chapter we review the donor and aid variables, while in chapter 5 we review the recipient country's environment and actions and external variables.

4.2 DONOR VARIABLES

Donors provide foreign aid for a number of reasons. The most commonly and publicly cited motive is the moral obligation of rich countries to reduce poverty, suffering and inequality in poorer underdeveloped countries. But foreign aid is also a political tool that is used by donor governments to further their own interests (Riddle 2007:99). In the discussion that follows we examine some of the motives behind foreign aid, and determine whether it is accurate to measure foreign aid against the indicator for economic growth, when in fact the donor country is using foreign aid to serve its own interests. If foreign aid is not given for the sole purpose of growth and development, then measuring the impact of foreign aid against a growth indicator is inherently inaccurate, illogical and misleading.

4.2.1 DONOR MOTIVES

Why do donors provide aid? According to Degnbol-Martinussen and Engberg-Pedersen (2003:10), the solidarity of foreign aid is based on the premise that the rich countries have a moral obligation to provide foreign aid to poorer countries to advance their development and economic growth. Endorsing human rights, supporting social justice and responding to extreme poverty, inequality and need are increasingly important components of the aid agenda. For example, in 2004, the British chancellor of the exchequer, Gordon Brown, addressing the Catholic Agency for Overseas Development (CAFOD), stated that aid and poverty reduction is 'our moral responsibility to each other' and that there was a need for Britain to 'awaken our conscience to the needs of not just neighbours but strangers ... to see every death from hunger and disease as if it were a death in the family' (Brown 2004:15). However, according to Riddle (2007:141), foreign aid is seldom provided for a single purpose, and there is always a mixed agenda bundled together with the aid package.

Foreign aid often reflects the foreign policy, and political and economic interests of the donor country, rather than the needs of the recipient country (Gounder 1994:99). National interest is an obvious motive behind foreign aid, and donors tend to support countries with which there are strong historical, cultural, political, economic and strategic ties. For example, Japan concentrates its aid in Asia; Britain and France favour their former colonies; and US aid is used to promote its foreign policy and strategic objectives (Ram 2003:97). From these examples it is clear that foreign aid is generally used to serve the needs of both the donor and the recipient. Donors provide foreign aid to achieve six objectives. These objectives include, first, the humanitarian motive, which is to provide aid during an emergency bringing immediate relief to, affected people.¹ Second, the economic

motive serves to develop markets for the donor's exports and secures access to scarce resources and raw materials from the recipient country. Third, the political and strategic motive is to ensure international security, to achieve the donor's global political aspirations, and to increase the donor's influence in the developing world. Fourth, the cultural motive is to promote the language and values of the donor society, which is particularly prevalent in French and British aid (Lancaster, in Whitfield & Fraser 2009:27). Fifth, historical and colonial ties are still a strong motive for foreign aid (Rogerson, in Browne 2006:9). Finally, as discussed above, aid is based on solidarity, that is, the moral imperative (Riddle 2007:91). The evidence from the literature supports the argument that foreign aid is used by donors for a number of reasons beyond economic growth and development in recipient countries. In the next section we examine the evidence from the literature in order to gauge the extent to which donor interests motivate foreign aid allocations.

4.2.1.1 DONOR MOTIVES: THE EVIDENCE FROM THE LITERATURE

Despite the public rhetoric about solidarity and the moral imperative of foreign aid, the evidence in the literature paints a different picture. Foreign aid is certainly used for promoting economic growth and development in recipient countries, but aid is also used to serve the interests of the donors. Economic interests, colonial history, political influence and voting patterns at the UN explain more about foreign aid than public speeches, White Papers and policy documents on foreign aid. The US for example provides approximately 30 per cent of its aid to Egypt and Israel for strategic reasons. France gives substantial aid to its former colonies, while Japan's aid is correlated with UN voting patterns. The result, according to Alesina and Dollar (2000:55), is that there is a weaker relationship between foreign aid and growth and development in recipient countries.

Early research concluded that donors were typically motivated by political, economic and strategic objectives when they made their aid allocations. A number of studies² concluded that the developmental or humanitarian motive played a relatively small role in the allocation of foreign aid (Ehrenpreis & Isenman 2003:8). McKinlay and Little (1979:243) for example found no evidence that US aid was allocated on humanitarian criteria. Similarly, Maizels and Nissanke (1984:891) observed that British, American, Japanese, German and French 'bilateral aid allocations are made ... solely ... in support of donors' perceived foreign economic, political and security interests'. In a more recent study, Alesina and Dollar (2000:33) found that foreign aid was determined as much by donors' political and strategic interests as it was by the economic needs and policy performance of the recipient countries. Countries such as France provided foreign aid to their former colonies, irrespective of policy performance, and the Nordic countries tended to supply foreign aid based on income levels, good institutions and openness of the recipient country (Alesina & Dollar 2000:33). Since the end of the Cold War there had been a slight shift in donor aid allocations away from political motives towards more developmental objectives, and US aid, once considered the least developmental, had increasingly begun to favour poor countries (McKinlay & Little (1979:243). There are indications in the recent literature (since early 2000s) that donors are beginning to afford higher priority to development and poverty reduction when making aid allocation decisions. However, economic, political and strategic motives remain dominant almost across the board. A DFID study in 2002 of the ten major donors found that there was increased emphasis on selectivity criteria³ that were based on economic growth and development objectives. The DFID 2002 survey also noted that among the large donors, politics and strategic interests continued to play a dominant role in determining donor aid allocations (in Ehrenpreis & Isenman 2003:9). This means that

there are limits to the influence that development criteria will have on foreign aid allocations, and that aid will still be used to promote the interests of donor countries.

In the next four sections we explore the economic, political, strategic, cultural, historical and colonial ties in more detail with some noteworthy examples of how donor motives reduce the impact of foreign aid on growth. However, we limit these examples to one major donor per motive, purely to demonstrate our argument that donor motives dilute the impact of aid on growth.⁴ We argue that by providing evidence from one donor, we can demonstrate the importance of the variable, and cast doubt on the current methodology used to measure the impact of aid on growth and development.

4.2.1.2 ECONOMIC MOTIVE

Since its inception, aid has been provided to serve the economic interests of the donor country. The most obvious form of economic interest is in tying aid to the purchase of services and products from the donor country. Aid can be linked to the procurement of in-kind products from the donor country, and the funding of large capital projects such as dam construction, which are undertaken by contractors from the donor country. China is a recent example, with Chinese companies building major capital projects in the recipient country (Brautigam 2009:153).⁵ When aid is tied, it means that the aid money must be used to buy products and services from the donor country (Riddle 2007:99). The tying of aid thus ensures that most of the aid money never leaves the donor country. For example, Jepma (1990:11) found that 70 per cent of bilateral aid from the European Union (EU) had led directly to procurement in the donor countries. When aid is tied, the recipient has no control over the procurement process, and is therefore unable to obtain the products from cheaper sources unrelated to the donor. This practice makes aid less effective and,

according to Jepma (1991:15), adds up to 20 per cent to the cost of procurement. In other words, tying aid to the donor country makes aid up to 20 per cent less effective. Donors also use aid to promote their own economic interests. For example, in 2002 the British prime minister, Tony Blair, refused to stop a major commercial deal to supply Tanzania with a £2.8 million British Aerospace System (BAe), used as a military air-traffic control system. BAe is a British multinational defence, security and aerospace company, headquartered in London with global interests, and is among the world's largest military contractors. The World Bank and several other donors objected, stating that the sophisticated BAe system was unnecessary and beyond Tanzania's means, but Tanzania, with British foreign aid, installed the system, even though it was not necessarily the most appropriate technology for the country (Porteous 2005:287). British economic interests (the selling of the BAe system was an inappropriate use of foreign aid) took precedence over the effective use of foreign aid. If foreign aid is used to serve the interests of the donor, then it is our contention that the impact of foreign aid cannot be measured solely against the indicator of economic growth in the recipient country(ies). Foreign aid is being used to meet two separate purposes and it is unsound to measure the impact of aid solely against the indicator of economic growth in recipient countries. But it is not only the economic motive that dilutes the effectiveness of aid. Foreign aid is used to further the political interests of donor countries.

4.2.1.3 POLITICAL AND STRATEGIC MOTIVES

Donors use foreign aid as a tool to further their political and strategic agenda. For example, donors use aid to reward a recipient's loyalty for siding with them during crisis negotiations, in influencing decisions in international forums and for providing a base for information gathering (Sogge 2002:41). Donors also use foreign aid to develop

relationships with the recipient countries in order to increase their own prestige and influence in the global economic, political and military arena. Donors provide aid to steer economic and political agendas and to reinforce their economic and political status in the world (Sogge 2002:42). Some donors provide foreign aid to stem the unwanted and negative effects of migration and terrorism (Sogge 2002:42; Riddle 2007:95; Browne 2006:105). US foreign aid is perhaps the most obvious example of how aid is used to serve the donor's political agenda.

Foreign aid is an essential tool in US foreign policy, and is used to support their geopolitical interests (USAID, in Riddle 2007:94). US foreign aid, at times, is used to pressurise developing countries to reform their political and economic policies to line up with US political and strategic ambitions. This was particularly common during the Cold War when US aid was used to resist the spread of communism. For example, Mozambique's switch from a socialist state to a free market democracy can be attributed directly to Western pressure and the use of foreign aid to force it into compliance with Western policy and dictates. In the early 1970s, Mozambique aligned itself with the Socialist bloc and embraced communism as its political ideology. In terms of the Cold War, Mozambique was in opposition to America and democracy. In 1983, when Inhambane Province in Mozambique was suffering from a severe famine, despite repeated appeals to the donor community, it took more than a year before the first consignments of food aid arrived there. The decision by the US government to deny Mozambique development and humanitarian aid influenced other donors and multilateral donors (such as the World Food Programme) to withhold their aid until the political problems between Mozambique and the US had been resolved (Abrahamsson & Nilsson 1995:100).⁶ To receive much-needed food aid, the Mozambican government was forced to accept a number of political

initiatives, including (1) a negotiated peace with South Africa (the 1984 N'komati Accord); (2) an economic recovery programme that included the gradual liberalisation of the socialist economy, replacing it with a market economy; and (3) membership negotiations with the World Bank and IMF. This statement by an American State Department official made the use of foreign aid to promote the US's political and strategic interests crystal clear (Abrahamsson & Nilsson 1995:101):

We made it clear to the government of Mozambique that our food aid is political. There are always conditions on aid, although they are often not explicit ... To get better relations with us, Mozambique had to demonstrate a willingness to change its economic policies. This was necessary anyway, because Africans are capitalists; Africans don't like socialism.

Alesina and Dollar (2000:33) found considerable evidence that foreign aid allocation decisions were determined by political and strategic motives. If foreign aid is provided to recipient countries to serve donors' political and strategic objectives, then it is irrational to try to measure the impact of aid against economic growth indicators.

4.2.1.4 CULTURAL, HISTORICAL AND COLONIAL TIES

Some donors use foreign aid to spread their culture and influence, and to maintain ties with their ex-colonies. France, particularly in Africa, is inclined to bias its aid towards the former French colonies. A significant driver of French aid is the emphasis on the spread of the French culture and language. In Africa for example more than 700 libraries and 70 cultural institutions have been established with French foreign aid (Degnbol-Martinussen & Engberg-Pedersen 2003:84). If French foreign aid is being used to spread the influence and culture of France, then when calculating the impact of aid, one would need to consider the spread of French culture as well as the impact of foreign aid on growth. This section, while brief, illustrates the important point that foreign aid is not only provided to recipient

countries for the promotion of economic growth, it is used to maintain historical and colonial ties with underdeveloped countries.

Closely linked to the expansion and preservation of cultural influence is the maintenance of historical and colonial ties with former colonies and protectorates. Most donors that had colonies retain ties with their ex-colonies. British aid policies maintain strong aid commitments to countries with close historical ties to Britain. For example, Botswana, Zambia and Malawi are all large recipients of British aid (Browne 2006:21). The largest share of foreign aid is given to members of the Commonwealth. Degnbol-Martinussen and Engberg-Pedersen (2003:86) pointed out that it was part of British foreign policy to give aid allocation preference to countries with close historical ties to Britain. Other countries with a strong bias towards ex-colonies include Belgium and France (Browne 2006:21). If countries such as Britain, Belgium and France are using foreign aid to extend their influence and maintain their colonial and historical ties, then aid is being used to serve more than one objective. Therefore, if foreign aid is used for multiple objectives, it should be measured against all objectives, and not solely against economic growth or development indicators.

4.2.1.5 SHOULD THE IMPACT OF AID BE MEASURED AGAINST GROWTH INDICATORS?

Foreign aid is provided to developing countries to serve not only the needs of recipient countries, but also donors' own objectives. Donors state publicly that foreign aid is provided to developing countries to promote economic growth, development and poverty reduction, but the evidence from the literature indicates that there is still a significant relationship between foreign aid and donor interests (Ehrenpreis & Isenman 2003:8;

Berthelemy 2005:20; Riddle 2007:98). Donors continue to provide foreign aid primarily to serve their own aims, and the secondary objective of aid is economic growth and development in the recipient country. Foreign aid is not supplied solely to support a development agenda, but rather serves a donor agenda, while at the same time providing assistance to the recipient country. Therefore one cannot expect foreign aid's performance to be measured and judged solely against the indicators of economic growth, especially if foreign aid is used to support the economic, strategic, influence and political interests of the donor countries.

4.2.2 DONOR FRAGMENTATION AND PROLIFERATION

As early as 1969, the Pearson Commission cautioned that too many donors were providing aid. Today there are over 100 large official bilateral aid donors (Riddle 2007:52). The 23 members of the Organisation for Economic Cooperation and Development (OECD) provide over 95 per cent of bilateral ODA, and another 14 donor countries provide the remainder. Fifteen major agencies provide up to 90 per cent of all multilateral aid, and the balance is supplied by 150 smaller multilateral agencies. Focusing on only the major donors, there are 37 major bilateral aid donors (excluding China) and 15 multilateral aid agencies. That is, up to 52 donors provide foreign aid to 180 recipient countries (Riddle 2007:52). In light of our discussion in section 4.2.1, this is hardly surprising, and supports the notion that aid is provided to serve the interests of the donor as well as those of the recipient country. If the major donors were to share the recipient countries among themselves, each would fund on average three or four countries. However, each developing country that is receiving foreign aid has up to 26 official donors (Riddle 2007:52). Again, as we saw in section 4.2.1, the number of donors supporting 180 recipient countries is hardly surprising, since foreign aid is used to further the political, strategic and economic objectives of the donor countries. But the devil is in the detail. Too

many donors providing aid reduce the impact of foreign aid and create coordination and programme effectiveness problems in the recipient country. Too many donors result in high transaction costs; too many projects; parallel structures; the siphoning of top skills out of government service by the donors; hence aid becomes ineffective and costly (Djankov, Montalvo & Reynal-Querol 2009:217). In the next five subsections we will briefly discuss each of these issues that reduce the impact of foreign aid on growth and development in the recipient country.

4.2.2.1 HIGH TRANSACTION COSTS

Donor fragmentation causes high transaction costs for the recipient government since donors impose their own accounting, procurement, reporting, auditing and evaluation procedures on the recipient country (Van de Walle 2001:202). Recipient governments are burdened with high numbers of donor delegations, missions and meetings. This results in competent recipient officials spending more time attending to donors than managing the country. The effectiveness and impact of aid is reduced when donor fragmentation is high (Djankov et al 2009:228).

Too many donors can be a nightmare for the recipient government. For example, in the mid 1990s Tanzania had approximately 1 500 projects, with their associated constraints, auditing, procurement and reporting procedures. In 2001 the Tanzanian Ministry of Cooperation wrote more than 2 400 quarterly donor reports, and government officials met over 1 000 donor delegations (Birdsall & Deese 2004:39). The donor proliferation problem in Tanzania escalated to such an extent that foreign aid was undermining the government's ability to manage the country. In desperation, the Tanzanian Ministry of Finance diplomatically declared April to July each year a 'mission holiday'. During a

mission holiday, donor missions were asked to stay at home so that the government had the time and space to get on with the job of managing their country (Birdsall & Deese 2004:39).⁷ Furthermore donors, as we saw in section 4.2.1, have their own agenda to promote, and therefore place high demands on the time of senior government officials in the recipient country (Sogge 2002:88). This results in a heavy administrative burden for the recipient country. In addition, too many projects cause a multitude of managerial and administrative activities. Too many donors, indirect administrative and managerial implications and their associated transaction costs make aid ineffective.

4.2.2.2 TOO MANY PROJECTS

Having too many donors in a country inevitably results in a proliferation of projects, because each donor follows its own agenda. Fragmented donor aid soaks up recipient government officials' time as they track thousands of disjointed projects in their country. In 2003 more than 50 donors funded 35 000 projects in 150 developing countries. This generated 35 000 annual reports and evaluations per year (Birdsall & Deese 2004:40).⁸ In 2002, Vietnam for example was receiving aid (5 per cent of GNP) from 25 bilateral donors, 19 multilateral donors and 350 international NGOs. Collectively these organisations were implementing over 9 000 projects, that is, about 1 project for every 9 000 people (Acharya, Fuzzo de Lima & Moore 2006:2). The recipient country is thus overburdened by projects; development action is splintered and uncoordinated; and, in many cases, projects overlap. Donors, through their actions, dilute the ability of foreign aid to have a positive impact on growth and development. In other words, in attempting to advance their own agenda, donors are reducing the effectiveness of foreign aid. But the problem intensifies as donors, in an effort to deliver on the project goals, sometimes create parallel structures alongside the government system.

4.2.2.3 PARALLEL STRUCTURES

In many developing countries, government structures are weak, ineffective and burdened with growing corruption (Van de Walle 2001:203). Because of these problems, and the need for donors to deliver tangible results to their home public, they tend to implement their aid projects through specifically created stand-alone project structures that replace the government or, worse, create a parallel system (Sogge 2002:91). According to Van de Walle (2001:203) and Sogge (2002:93), the creation of parallel structures is inefficient, and makes foreign aid less effective than it might have been, had there been fewer donors that were focused on developing local institutions and capacity in the recipient country. But, as we discussed in section 4.2.1, the donors are pursuing their own agendas and therefore reducing the impact of foreign aid, making aid costly and ineffective. And it gets worse. In an effort to deliver their programmes, donors even drain the skills from the recipient country.

4.2.2.4 SKILLS DRAIN

A plethora of donors, the proliferation of projects, and parallel systems result in a skills drain as civil servants leave government employment for the greener pastures of the aid industry. If the average developing country has 23 bilateral donors operating in it, each donor will have a complement of local staff, including managers, project officers, accountants, receptionists, secretaries, logisticians and human resource managers. For example, a World Bank project in Kenya lured civil servants away from government employment to staff the bank's project. The World Bank was offering salaries of between \$3 000 and \$6 000 a month, while a senior government economist earned a civil service package of \$250 a month (Van de Walle 2001:204). Donors, with their higher salaries,

benefits and skills development, drain away skilled staff from government service, thus undermining institution building in the recipient country. Donors are simultaneously building and destroying institution capacity in the recipient country. Donor action in a recipient country can dilute the ability of foreign aid to have a positive impact on economic growth and development as skilled government officials are lured away from government service, thus robbing government of the capacity to build strong institutions.

4.2.2.5 AID BECOMES INEFFECTIVE AND COSTLY

Donors are under pressure to produce tangible results for their aid programmes, therefore they favour projects that have tangible outputs, for example building classrooms, health clinics, water wells, and rural roads, all of which are identifiable and popular with the public back home, but not necessary the most effective use of foreign aid. For example, in the mid 1990s Guinea's primary education sector was being funded by six multilateral donors,⁹ four bilateral donors¹⁰ and a string of INGOs, all implementing numerous development projects (Van de Walle 2001:203). Primary school construction costs were anywhere from \$130 to \$878 per square metre, depending on which donor was funding the project. Donors who spent \$878/m² (because of tying aid) could reasonably have funded a building for as little as \$130/m², and the remaining \$748 could have been used to resolve Guinea's urgent needs for textbooks and teachers (Birdsall & Deese 2004:41). Donors serving their own agendas make aid ineffective. As we discussed in section 4.2.1, donors do not provide aid solely according to the needs of the recipient country. Foreign aid is used to serve a number of donor-driven objectives. When many donors are involved, the impact of aid is diluted and in some cases aid may even have a negative impact on growth and development. Too many donors result in high transaction costs; they soak up the valuable time of government officials; and inevitably bring about a proliferation of fragmented

projects that overlap and duplicate efforts in the recipient country. Fragmented aid is ineffective and expensive. Uganda's minister of finance lamented that aid from donors can be 'very expensive' (Birdsall & Deese 2004:40). Therefore, if donors provide aid based on their objectives, as we discussed in section 4.2.1, and if donors through their actions (as discussed above) make aid ineffective, then we argue that it is inappropriate to measure the impact of foreign aid solely against the indicators of economic growth. Furthermore, if donor actions and agendas dilute the impact of aid on growth and development, any methodology (as discussed in section 3.6.6) that attempts to measure the impact of foreign aid must take these donor variables into account. But donor action is not the only cluster of variables that influences the impact of aid on growth and development; aid itself can have a negative impact on growth in a recipient country.

4.2.3 PREDICTABILITY AND VOLATILITY OF AID FLOWS

Economic theory predicts that if aid is invested productively, it will have a positive impact on growth (see section 2.2.1). Lack of investment capital was one of the finance gaps identified by the early growth models (discussed in sections 2.2.2 and 2.2.4). If aid flows are unpredictable, then aid is unlikely to be invested by recipient governments, and is unlikely to promote growth in the short or long term (Easterly 1999:434). Bulíř and Hamann (2003:66),¹¹ studying the empirical evidence on the volatility and uncertainty of aid flows, found that aid was highly unpredictable and that donor disbursements were consistently lower than their aid commitments. Recipients therefore could not reliably predict their aid income based solely on donor commitments.¹² Similarly, Lensink and Morrissey (2000:32) found that when foreign aid was unpredictable, there was a negative relationship between aid and economic growth, but if they included aid as being unpredictable in their model, they found that aid could have a positive impact on growth. Therefore, Lensink and Morrissey demonstrated how aid flows could reduce the impact of aid on growth and

development. If aid is unpredictable, it cannot be reliably invested, since recipients are uncertain whether they will receive all the committed aid, so they tend not to make concentrated investment commitments, which is a contradiction to the early growth models (see section 2.2.2 and 2.24). Therefore the unpredictability of aid lowers the levels of investment, and this in turn has a negative impact on growth (Lensink & Morrissey 2000:31). Unpredictable foreign aid flows reduces the effectiveness of aid. If donors honoured their commitments to ensure that aid was more predictable, the return on aid would increase. However, if donors were to live up to their promises and deliver all the aid that is pledged, this raises the question of how much aid is enough to stimulate economic growth and development. Is it possible for a recipient country to receive too much aid?

4.2.4 DIMINISHING RETURNS OF AID

Too much aid can be ineffective, simply because the recipient country cannot use it efficiently. If a recipient country receives too much aid, a number of variables reduce the impact of aid on growth and development. High aid inflows may have a negative impact on the recipient's economy. Too much aid capital can cause aid-induced Dutch disease (discussed in section 4.3.1), bring about exchange rate volatility, and affect the recipient's capacity for absorption (absorptive capacity is discussed in section 5.2.2).

The evidence from the literature is that increased aid can be problematic. Researchers found that aid was subject to diminishing returns and that there was a saturation point,¹³ at which aid became ineffective. But determining the saturation point proved difficult. Hadjimichael et al (1995 in Lensink & White 2001:61) found saturation at 25 per cent; Durbarry et al (1998:17) at 40–45 per cent; Hansen and Tarp (2000:125)¹⁴ at 25 per cent; Lensink and White (2001:61) at 50 per cent; and Islam (2005:1489) at 5.8 per cent. According to these researchers, saturation point is thus somewhere between 25 and 50

per cent. Collier (2006:1495) argued realistically that if aid was simply scaled up, dollar for dollar, it would be less effective than existing aid because of diminishing returns. But not all researchers agree with the principle of diminishing returns.

Gomanee et al (2003:16) found that there was no evidence that aid was subject to diminishing returns. These authors found that there was a threshold beyond which aid became more effective, but they did not find a second threshold at which aid grew less effective. Their results indicated that aid was more effective in countries receiving relatively higher levels of aid (Gomanee et al 2003:16). Nkusu (2004:3) found that although the question of diminishing returns was plausible, the model used by Lensink and White (1999 and 2001) was structurally unsound and the model used by Hadjimichael et al (1995) was more acceptable, although more research was needed to better understand the point at which aid is subject to diminishing returns.

Although there was some controversy regarding the question of diminishing returns, consensus in the literature was that aid was subject to diminishing returns and that there was a threshold, which was dependent on the environment and characteristics of the recipient country. If aid is subject to diminishing returns, then researchers must include the diminishing returns variable in their models, once again demonstrating the problems with the current methodology. Lensink and White (1999:19) recommended that a ceiling should be placed on the aid : GNP ratio, but exactly where that ceiling should be would depend on the specific contexts of individual countries. While aid may be subject to diminishing returns, aid flowing into the recipient country can have negative effects on the economy, therefore reducing the impact of aid on growth and development.

4.3 AID VARIABLES

Aid inflows into the recipient country can further reduce the impact of aid on growth and development. Large injections of aid capital into a recipient economy can result in aid-induced Dutch disease. Too much foreign aid for too long can create dependency, remove incentives for investment, savings and tax collection, and result in aid fungibility. In this section we will examine the evidence from the literature to determine the impact of aid variables, namely Dutch disease, aid dependency, removal of incentives, and aid fungibility, on economic growth and development. The transfer of aid funds from a donor country to a recipient country can cause havoc within the recipient's economy.

4.3.1 AID-INDUCED DUTCH DISEASE

Dutch disease¹⁵ usually occurs when a country experiences a sudden windfall in earnings. For example, when large gas fields were discovered in the Netherlands in the 1960s, the sudden massive foreign income generated by the gas resulted in local currency appreciation, increased demand for imported products, and declining demand for locally produced products. A sudden large increase in wealth (foreign currency) pouring into a country has a negative impact on that country's economy. As the local currency becomes stronger, the local export market becomes increasingly less competitive on the international market (Ebrahim-Zadeh 2003:1). Similarly, when a country is highly dependent on aid, or if aid flows are suddenly increased, then aid can induce a form of Dutch disease. If all foreign aid were spent on imports, there would be no change in the balance of payments. In other words, the increase in imports would be financed completely by aid inflows. In this scenario, aid would not negatively affect the country's money supply, exchange rates or domestic economy (Heller & Gupta 2002:135). On the other hand, if a

significant share of aid income is spent on non-tradable goods,¹⁶ then the price of domestic services and goods will increase, since local purchases will be made with aid money. Aid money is converted into local currency, which increases the supply of foreign exchange in the country, and expands the local monetary base, which in turn increases local demand, some of which will be met by additional imports. But the demand for non tradable goods and their limited supply would ratchet up local prices, leading to the inflation of domestic prices. Expanding imports would have a weakening effect on the trade balance (Heller & Gupta 2002:135). If the recipient country has a flexible exchange regime (something that World Bank and IMF encourage), the increased supply of foreign currency that is not used to pay for imported goods and services would cause the local currency to appreciate. The impact on the economy is twofold. First, domestic prices for tradable and non-tradable goods rise, resulting in inflation and, second, the local currency appreciates, which has a negative impact on exports and the balance of payments. Local producers and industry would not be as competitive, and their export capacity would be undermined by the appreciation of the local currency (Heller & Gupta 2002:136).

The evidence in the literature draws attention to the challenges of too much aid, particularly the recipient country's capacity to absorb aid and the potential effects of aid-induced Dutch disease. Heller (2005:7) and Adam and Bevan (2006:261), evaluating the impact of aid-induced Dutch disease, found that when there was an increase in aid inflows, aid caused short-term Dutch disease in the economy. Similarly, Rajan and Subramanian (2005:31) found that a large inflow of aid induced an overvaluation of the local currency and resulted in Dutch disease. Rajan and Subramanian (2005:32) noted that too much aid and the negative impacts of Dutch disease caused a decline in the growth of the manufacturing sector of the economy. However, Adam and Bevan (2006:261) found that if

aid was invested in public infrastructure, the impact of foreign aid could be positive, although with an urban bias. Nyoni (1998:1235) evaluated the relationship between foreign aid and real exchange rate to assess the impact of aid-induced Dutch disease in Tanzania and found that aid inflows caused depreciation in the exchange rate. Nyoni therefore concluded that aid did not cause Dutch disease in Tanzania. However, more recently Arellano, Bulif, Lane and Lipschitz (2009:87) found that foreign aid increased the risk of Dutch disease, which had a negative impact on economic growth and development.

The evidence from the literature indicates that there was a possibility that too much aid might flow into the recipient country, leading to aid-induced Dutch disease, which could negatively affect the economy of the recipient country. Since economic theory argues that the injection of aid into the recipient country should result in economic take-off to sustained growth (see sections 2.2.2, 2.2.3 and 2.2.4) we can conclude that high volumes of foreign aid, if not carefully managed, can have a negative effect on the economic growth in the recipient country. Furthermore, if we wish to determine the impact of foreign aid on growth and development, then the methodologies that are used to measure this effect must make allowances for the effects of aid-induced Dutch disease. Too much aid can also remove incentives from recipient countries to increase tax income, increase domestic savings and invest in infrastructure.

4.3.2 AID REMOVES INCENTIVES

Governments of developing countries that receive high volumes of foreign aid lose the incentive and ability to rigorously manage the state budget and collect taxes. In an aid-dependent budget, there is little relationship between expenditure and the generation of state income through tax collection. The evidence from the literature showed that aid had a negative impact on the motivation of recipient countries to increase tax income, savings

and investments. Bauer (1976) found that foreign aid delayed the maturation of institutional capacity and the ability to collect tax revenue (in Moss, Petterson and Van de Walle 2006:10). Researchers such as Griffin (1970:106), Ghura (1998, in Moss et al 2006:13) and Knack (2001:313) all found that aid reduced taxation, and that the recipient made less effort to collect income tax. Similarly Braütigam (2000:48) observed that 71 per cent of African countries with an aid:GNP ratio above 10 per cent had underperformed in their tax collection efforts. Further negative relationships between foreign aid and domestic tax were found in Pakistan (Rodriguez, Morrissey and McGillivray 1998:1241), Zambia (Fagernas & Roberts 2004, in Moss et al 2006:13), the Philippines (McGillivray & Ahmed 1999:390) and Côte d'Ivoire (McGillivray & Outtara 2005:261). However, not all research was negative. A number of positive relationships between aid and tax revenue were found in Indonesia (Pack & Pack 1990:193), Ghana (Osei et al 2003, in Moss et al 2006:13), Uganda, and Malawi. The consensus in the literature was that aid did have a negative impact and reduced the recipients' incentives to increase tax collection, boost domestic savings and make the tough budget decisions that are necessary when there is no anticipated aid bale-out. Therefore aid, especially too much aid, can have a negative impact on growth and development through the removal of incentives to increase tax income, domestic savings and productive investments.

Referring back to our discussion in section 2.2, economic theory and the use of foreign aid were intended to fill the savings, investment and foreign exchange gaps. However, we have a situation in which aid in itself is causing effects that are the opposite of what it was intended to do. Foreign aid was meant to increase domestic savings (including tax collection) and investment, but (as we have seen in the discussion above) foreign aid can remove the incentives from recipient governments to save and invest. This is a direct

contradiction of the principle of foreign aid and economic development (see section 2.2.1, 2.2.2, 2.2.3 and 2.2.4). Therefore any attempt to measure the impact of foreign aid on growth and development must take into account that aid may be causing effects that are contrary to economic theory. If foreign aid is given with the intention of creating economic growth and development, then we must assume that it is used exactly as intended. However, as we will see in the next section, recipient governments can divert aid to unproductive investments (aid fungibility). Aid fungibility contradicts economic theory and growth models that assumed that all foreign aid was provided with the intention of filling the savings and investment gaps (see section 2.2 for more details).

4.3.3 AID FUNGIBILITY

Donors provide foreign aid to developing countries in order to promote economic growth and development (discussed in chapter 2). Donors assume that aid capital will be used by recipients to fill savings and investments gaps, as dictated by the early growth models (discussed in section 2.2.2 and 2.2.4). However, aid is fungible when it replaces expenditure that the recipient would otherwise have undertaken (Feyzioglu, Swaroop & Zhu 1996:2). If a donor for example refuses to provide aid for military expenditure, but continues to provide development aid, this does not stop the recipient from spending money on the military. This is possible because donor aid capital allocated to the 'development sectors' frees up government capital, which can be re-allocated to other expenditure (Khilji & Zampelli 1991:1096). Nurske (in Khilji & Zampelli 1991:1096) provides a simple illustration of aid fungibility:

A low-income country wanted to rebuild an ornate opera house. It applied for an aid loan to do so. The loan was refused on the grounds that the opera house was not a development-orientated expenditure. The country had also been planning as part of its development program to build a dam with hydro-electric generators. It recognised an opening in the situation and returned to the potential lender asking this time for a loan

to build a dam. The lender, correctly identifying this as developmental infrastructure, granted the loan. Whereupon the country built both the dam and opera house.

Aid cannot be constrained to specific purposes, no matter what the intention of the donor. Donors are sometimes misled into thinking that providing foreign aid to fund a specific project will reduce the problem of aid fungibility because their aid money will be spent on a specific measurable and identifiable set of activities. But this is an illusion, according to Griffin (1970:103), World Bank (1998:61) and Collier (2006:1486).

The evidence in the literature indicated that aid fungibility was a problem that affected recipients differently, depending on their characteristics and context. Griffin (1970:103) was one of the first researchers to identify the problem of aid fungibility. McGillivray and Morrissey (2001:118) found aid was fungible, with a tendency of recipients to allocate aid for purposes not intended by donors. Mavrotas (2002:552) found that the degree of aid fungibility was linked to the type of aid provided by donors. In a number of country-specific studies aid was found to be fungible in the Dominican Republic (Pack & Pack 1993:264), Sri Lanka (Pack & Pack 1998, in Pettersson 2004:5) and India (Swaroop, Jha & Rajkumar 2000:307). But not all research found aid was fungible. For example, Pack and Pack (1990:193) found that aid was not fungible in Indonesia, and Ekman and Metell (1993, in Pettersson 2004:5) found that sectoral aid in Kenya did not seem to be fungible. However, as Lensink and White (2000:10) pointed out, aid was fungible, but the degree of fungibility was dependent on the country context. Similarly Pack and Pack (1993), Boone (1996:5) and Collier (2006:1486) all observed low aid fungibility in recipient countries that were highly dependent on foreign aid, and high levels of aid fungibility in countries that were less dependent on aid. Most researchers therefore found that aid was fungible or at least partially fungible.

The consensus in the literature was that aid was at least partially fungible, thus reducing aid's ability to promote economic growth and development. The degree of fungibility depends on the characteristics and context of the recipient country; the type of aid that donors provide (for example direct budget support, sector aid, loans, grants or projects); and the levels of aid dependency of the recipient country. Therefore if aid fungibility is a variable that reduces the impact of foreign aid on growth, we can argue that in each study that attempts to measure the impact of foreign aid on growth and development, the methodology must take cognisance of aid fungibility and its potential effects on the impact of aid on growth and development.

4.4 CONCLUSION

Foreign aid is provided to developing countries to serve not only the needs of recipient countries, but also donors' own political, strategic and economic agenda (discussed in section 4.2.1). If foreign aid is provided to serve donor objectives, it is inappropriate to measure the impact of foreign aid merely against the indicator of economic growth in developing countries. Since donors use foreign aid to serve their own objectives, we can expect to find a proliferation of donors in recipient countries, which is indeed the case, as demonstrated in section 4.2.2. Therefore because of too many donors providing aid to too many countries through too many projects, we find that there is duplication and inefficiency in the provision of foreign aid, which dilutes its impact. The high number of donors in recipient countries results in high transaction costs, parallel structures, and even skills drainage. Foreign aid is unpredictable and volatile, which means that recipient governments are unable to make productive investments, thus further reducing the impact of foreign aid on growth and development (as pointed out in section 4.2.3). In a number of countries, donors are providing too much aid. Since aid is subject to diminishing returns

(see section 4.2.4) the impact of aid on growth and development is further reduced. But donors are not the only problem with foreign aid.

The flow of foreign aid into developing countries can further reduce the impact of aid on growth and development (as demonstrated in section 4.3). Aid-induced Dutch disease (discussed in section 4.3.1) produces a negative impact on the economy, and leads to the overvaluation of the local currency, a subsequent decline in local industry, and reduced investment in local manufacturing. Export products from the developing country become uncompetitive on the global market, therefore exports decline. These three problems are in direct contradiction to the growth models discussed in sections 2.2.2 and 2.2.4. Therefore foreign aid is counterproductive and, as demonstrated in section 4.3, has a tendency to decrease the incentives of recipient governments to scale up domestic tax collection, improve domestic savings, make productive investments, and exercise budgetary austerity measures. When too much foreign aid is readily available, it is easier for recipient governments to request more aid than to make the tough choices needed to develop strong disciplined state institutions that live within their budgets. Aid, as discussed in section 4.3.3, is at least partially fungible, therefore further reducing its effect on economic growth and development. The degree of fungibility depends on the characteristics and context of the recipient country; the type of aid that donors provide (for example direct budget support, sector aid, loans, grants or projects); and the levels of aid dependency of the recipient country.

In this chapter we have shown that donor motives, donor actions and even the inflows of foreign aid reduce the impact of foreign aid on growth. Therefore, based on the evidence, it is our argument that every study that attempts to measure the impact of foreign aid must take all these variables into consideration. The methodology used to measure the

effectiveness of aid must take cognisance of the donor variables (donor fragmentation and proliferation, unpredictability and volatility of aid income and diminishing returns) and the aid variables (Dutch disease, incentives to tax, save and invest and the fungibility of aid). Because donors use foreign aid to serve their own agendas, this raises serious doubts about the rationale of measuring the impact of foreign aid solely against the indicators of economic growth. However, recipient action, the country environment, and other external variables can further reduce the impact of foreign aid on growth and development. In chapter 5 we will discuss the role that aid recipients play in reducing the impact of foreign aid, and consider the external factors that further dilute the impact of foreign aid on growth and development.

NOTES

¹ As discussed in section 1.6, we ignore the humanitarian motive since the provision of humanitarian aid is outside the scope of this study.

² McKinlay and Little (1977, 1978a, and 1978b); Maizels and Nissanke (1984); McKinlay and Little (1979:243).

³ These criteria include policy environment (Burnside & Dollar 1997, 1998 and 2000); high poverty levels (Collier & Dollar 2002); governance and political stability (Chauvet & Guillaumont 2002); and absorptive capacity (Clemens & Radelet 2003) (DFID 2002, in Ehrenpreis and Isenman 2003:6). The papers referred to behind each criterion used in aid allocations indicate some of the more prominent research papers that brought such issues to the fore in the debate regarding aid effectiveness. They are shown here to reinforce the point that aid effectiveness research has had an impact on the allocation of foreign aid.

⁴ It is beyond the scope of the study to examine the detailed motives of each major donor, which would make the discussion both tedious and lengthy.

⁵ For more detail on Chinese aid, please refer to Brautigam (2009).

⁶ In 1983 Mozambique was still a socialist country and allied to the Soviet Union, putting it at loggerheads with the US.

⁷ The timing of the mission holiday is no coincidence. This is the time of year that northern hemisphere countries have their summer holidays and also the peak season for donor missions to the developing world. By declaring this peak season 'off limits', Tanzania was able to reduce the overall flow of donor missions.

⁸ Please note that these figures refer only to bilateral aid, and do not consider the additional burdens of multilateral aid and INGOs and national NGOs that also design and implement development projects in developing countries.

⁹ UNICEF, World Bank, African Development Bank and the European Union.

¹⁰ US, France, Japan and Canada.

¹¹ Lensink and Morrissey (2000:32) reached a similar conclusion in their study.

¹² Also see Lensink and Morrissey (2000:32).

¹³ The saturation point is the proportion of aid to GNP.

¹⁴ Hansen and Tarp (2000:125) believed that the point at which aid reached saturation was at the aid : GNP ratio of 25 per cent. See note number 14. However, they warned that the indication of a turning point should be interpreted with caution.

¹⁵ If a developing country experiences an increase in income – for example the discovery of gold – and foreign currency pours into the country, this adversely affects the valuation of the local currency. If all the foreign exchange were spent on imports, there would be no impact on the demand for foreign currency, or for additional domestically produced products. But if the currency is converted into local currency, and then used to buy locally produced products or services, then there is an appreciation in the real exchange rate, and a weakening in the competitiveness of the country's exports, resulting in a decline in the traditional export sector (Ebrahim-Zadeh 2003:2). Since there is an increased demand for locally produced products and services, labour and resources will move out of the export sector – which is no longer competitive and therefore is not earning s much income – into the domestic non-traded products market to meet the increased demand and profits in this sector. The result is a shrinking in the traditional export sector, which usually has a negative impact on economic growth and on the poor. This phenomenon is known as Dutch disease.

¹⁶ Non-tradable goods include water, electricity, rent, services, housing and other immovable assets.

CHAPTER 5: RECIPIENT AND EXTERNAL VARIABLES

5.1 INTRODUCTION

In the previous chapter we demonstrated how donors' motives, their actions and the flow of aid itself reduce the impact of foreign aid. But these are not the only variables that contribute to lowering the impact of foreign aid on growth and development. The recipient country's environment, institutions, and ability to absorb foreign aid can contribute to a reduction of the impact of foreign aid on growth and development. Additionally, external variables outside the control of recipient countries reduce the impact of foreign aid. In this chapter we will continue our analysis of the variables that can determine the impact of foreign aid in terms of recipient actions, the context of the recipient country and external variables.

5.2 RECIPIENT ACTIONS AND CONTEXT

In this section we evaluate how recipient variables may dilute the impact of foreign aid. The main recipient variables are the policy environment, governance and institutional capacity, the recipient's absorption capacity, and the use of foreign aid to fund public consumption. These variables are important since they demonstrate that foreign aid does not operate in a vacuum. When we wish to determine the impact of foreign aid on growth and development, we need to take these variables into consideration.

5.2.1 RECIPIENT POLICY ENVIRONMENT

In this section we determine from the literature whether the recipient's policy environment has any impact on the effectiveness of foreign aid. We discussed in section 2.4.2 that foreign aid has been used since the early 1980s to force recipient countries to adopt

neoliberal economic policies. In this section we explore the question of the recipient policy environment, and determine whether the neoliberal policies being forced upon recipient countries are the most appropriate policies for growth and development.

Burnside and Dollar (2000:847) found that 'aid has a positive impact on growth in developing countries with good fiscal, monetary and trade policy, but has little effect in the presence of poor policy'. Their study provided donors and supporters of foreign aid with the evidence they needed to prove that aid could be effective. Here was an explanation as to why aid was not delivering the expected results. The study proposed a fix to the problem of foreign aid ineffectiveness. Foreign aid worked better in countries with a good policy environment, therefore the recommendation was that donors should provide aid only to countries with a good policy environment. Their conclusion was corroborated by a number of studies¹ that found that a good policy environment improved the impact of foreign aid on growth and development. But the Burnside and Dollar (2000) study did not go unchallenged in the literature.

Two groups of researchers disagreed with the importance of the policy environment. The first group agreed that in principle the policy environment was important, but that its significance was less clear or less robust than suggested by Burnside and Dollar. For example, studies by Ehrenpreis and Isenman (2003:15) and Dalgaard et al (2004:212) found that aid had a positive impact on growth, but the relationship between aid and policy was weak. While Hansen and Tarp (2000:123) found that 'there is evidence that economic policies have an impact on the marginal productivity of aid', they reminded us that growth and foreign aid exist in a complex and changing world, and that it may well be that foreign aid works best in the countries that need aid the least.

While many papers supported the argument that aid needed a good policy environment to be effective, a second group of researchers found that the role of the policy environment was irrelevant to the impact of aid on growth and development. For example, Dalgaard and Hansen (2001:37), in a reassessment of the Burnside and Dollar study, using the same data, found that foreign aid had a positive impact on growth, irrespective of the policy environment. Similarly Easterly et al (2004:779), in an evaluation of the aid-policy relationship, found that there was no relationship between foreign aid and the recipient's policy environment. Furthermore, a number of studies found aid had a positive impact on economic growth, irrespective of the policy environment, including Hansen and Tarp (2000:123), Maurotas (2002:46), Clemens et al (2004:38) Islam (2005:1467), and Rajan and Subramanian (2008:643). The argument that aid works only in a good policy environment is debatable, but perhaps the answer can be found in the conclusion of the next two studies in which the researchers acknowledged that the policy environment may be an important factor for growth. Gomanee et al (2003:15), in a study of 131 aid-recipient countries, found that the impact of aid on growth was not dependent on a good policy environment. However, they agreed that economic policies might influence growth, and possibly some policies might improve the effectiveness of aid. Similarly, Guillaumont and Chauvet (2001:87) found no evidence that a good policy environment improved the impact of foreign aid, but they agreed that 'of course improved policy is an important factor of growth'.

The links between aid policy and growth are complex. To conclude that aid works only in a good policy environment is perhaps being too simplistic. There was consensus in the literature that the recipient's policy environment was important to growth, and a poor policy environment could reduce the impact of aid on growth and development. Therefore, for this study we will accept that the recipient's policy environment is an important variable for

foreign aid and that a country with good economic policies will probably use aid more effectively.

While we accept that a good policy environment is an important variable, what is a 'good policy environment'? In section 2.4.1 we discussed the transition in development economics from import substitution of the 1950s and 1960s (see sections 2.2.2 and 2.2.4) to the adoption in the 1980s of the neoliberal economics of the Washington Consensus. As discussed in section 2.4.2, foreign aid underpinned the World Bank and IMF SAPs, which were used to force recipient countries to adopt neoliberal economic policies. However, is neoliberal economic policy the right policy for economic growth and development in underdeveloped countries?

5.2.1.1 IMPOSED NEOLIBERAL ECONOMIC POLICIES

If we accept that the policy environment is important to growth and development, it raises the question as to what constitutes a good policy environment and what economic policies should poor developing countries adopt? Neoliberal economic policies were forced upon aid recipients in the form of SAPs (see section 2.4.2). Foreign aid underpinned the imposition of neoliberal economic policies on the recipients of aid. In section 4.2.1.3 we saw a perfect example of aid being used to force Mozambique to make the shift away from communism and to adopt a free market economy (neoliberalism). Mozambique, in desperate need of aid, was compelled to make certain policy changes before aid was provided. However, foreign aid is not having a positive impact on growth because it is possible that the neoliberal economic policies promoted by donors hinder growth. Reinert (2007:xxvii) argued that the promotion of neoliberalism by the donors and the use of foreign aid to enforce their policies would not create development and growth, but a form of welfare colonialism in which the rich countries maintained their political and economic

dominance over poor countries. Rich countries export manufactured products and services (increasing returns in imperfect competition), while poor countries export commodities (diminishing returns and perfect markets). Neoliberalism encourages poor countries to export agricultural goods and commodities. Neoliberalism, by forcing poor countries to adopt 'good policies', results in these countries opening their markets to cheap products manufactured in rich countries. Poor countries are not allowed to impose import tariffs, subsidies, emerging industry protection or control foreign exchange. This strategy, which incidentally is opposite to the way in which developed countries industrialised, ensures that poor countries remain poor and unlikely to industrialise.

The argument that the neoliberal policies are the 'wrong policies' is supported by evidence from the South East Asian countries, where economic growth occurred through ignoring the neoliberal economic model. For example, China, Japan, Korea, Taiwan and Thailand combined the centralised state system with the market economy (Chang 2005:50). Subsidies and performance standards² were maintained to encourage growth and development. The system used in South East Asia was a gradual transition from a central planning economy to a market economy, and the state played a key role in the transition. Using a non-neoliberal policy model (1960–2000) for growth and development in Asia resulted in the poverty rate falling from 65 per cent to 17 per cent; infant mortality shrinking from 141 to 48 per 1 000 births; and life expectancy increasing from 41 to 67 years (Amsden 2007:9). The Korean economic miracle was a blend of state intervention and market incentive, encouraging businesses in Korea to make profits and prosper. Tariff protection, state subsidies, and cheap credit were used for a limited time to nurture emerging industries and protect them from stiff external competition. State support was maintained only long enough for the emerging industries to absorb new technology, develop skills and become internationally competitive (Chang 2007:15). Korea, however, is

not an exception to the rule. Nearly all developed countries, including Britain, US, Sweden and Denmark, used protection and subsidy mechanisms, while resisting direct foreign investment that could threaten their local industry. For a long time Britain and the US were among the most protected economies in the world (Chang 2007:17). Successful industrialisation, economic growth and development did not happen because of neoliberal economic policy; it was achieved in a policy environment that is the exact opposite of the neoliberal economic model.

Underdeveloped countries that are recipients of foreign aid and are forced to embrace neoliberal economic policy are prevented from emulating the rich countries' development path, and foreign aid is the tool used to ensure that poor countries comply with the non-emulation clause. 'The main difference between rich and poor countries is that rich countries have all moved through a stage without free trade, which when successful, sequentially made free trade desirable' (Reinert 2007:xxix). Underdeveloped countries today are facing the prospect of being trapped as producers of agricultural products (coffee, sugar) and raw materials (copper, coal, aluminium). Neoliberal policy reform strategies, supported by foreign aid, ensure that poor countries remain locked into exporting raw materials and consuming products manufactured in developed countries. Many poor countries have to export raw materials to balance their budget, and they cannot replace raw materials with manufactured goods, because they have been forced to open their markets, reduce tariffs and abolish subsidies. Without any form of intervention or protection, developing countries have little prospect of building their critical industrial base. This brief examination of what constitutes 'the right policy environment' means that if we accept that foreign aid should be provided solely to countries with good policy – as suggested by Burnside and Dollar (2000:845) and as discussed in section 5.2.1.1 above –

it may well be that in the adoption of good policies aid-recipient developing countries are destined never to industrialise.

As discussed in section 5.2.1.1 above, consensus in the literature was that the recipient's policy environment was important to growth and that a poor policy environment could reduce the impact of aid on growth and development. While we accept that the recipient's policy environment is an important variable for foreign aid effectiveness, there are two challenges to this position. First, poorly governed countries should not receive less money; they should receive more aid, but aid should be disbursed through adapted or different aid strategies. Second, if the policy environment is important to economic growth and development, there are question marks over what constitutes a good policy environment and what economic policies aid-recipient countries should adopt. If foreign aid is provided only to countries with good policy – which in donor terms means a neoliberal economic one – it has been shown that neoliberal economics is not necessarily the best growth path for developing countries to follow. From the evidence presented in this section, the adoption of neoliberal policies may well condemn aid-recipient countries to a slower, less effective growth path. Therefore since donors promote neoliberal economic policies – which, as Reinert (2007:xxvii) and Chang (2007:15) have demonstrated, may be the wrong policies for growth and development – through the enforcement of the wrong policies, aid may be reducing the impact of foreign aid on growth and development. Neoliberal economic policies ensure that growth in aid-recipient countries will not achieve the levels experienced in other developing countries, for example the South East Asia NIC. Therefore donors have created a system in which the economic policies they are promoting ensure that developing countries do not industrialise (Reinert 2007:xxvii). Donors who use aid to serve their own interests (as discussed in section 4.2.1), through their inappropriate actions (see section 4.2.2 and section 4.2.3), and through the

promotion of neoliberal economic policy (as discussed above) have set up a foreign aid system that is unlikely to have any positive impact on growth and development. In the section that follows, the capacity of the recipient country to absorb and use aid effectively is discussed.

5.2.2 ABSORPTIVE CAPACITY OF RECIPIENTS

Since the early 2000s, there has been a big push for doubling foreign aid. In 2001 an influential UN panel proposed that foreign aid should be increased by \$50 billion a year to meet the Millennium Development Goals (MDGs). The Commission for Africa recommended the doubling of aid to Africa, and the UN's Millennium Project proposed an extra \$135 billion in aid per year by 2015. The US developed the Millennium Challenge Account, designed to provide an additional \$5 billion per year in bilateral aid, and the World Bank called for doubling foreign aid (Vásquez 2003:1; Moss & Subramanian 2005:3). While it may seem that increasing foreign aid will result in more growth and poverty reduction, the evidence is that the capacity of developing countries to receive and use aid effectively is one of the causes of the ineffectiveness of aid. Absorptive capacity means the ability of a recipient country's economy to use aid efficaciously and it includes short-term and long-term constraints. These constraints involve inadequate managerial capacity, lack of infrastructure and equipment, ineffective technical and managerial skills to scale up public services, slow institutional development, and lack of institutional capacity to manage aid inflows effectively (Killick 1991:1).

If a recipient country receives too much aid, and is unable to absorb and use that aid effectively, it can result in a number of macro economic problems. Countries without the capacity to manage large aid inflows experience problems with the unpredictable and volatile nature of aid. Badly managed aid inflows can negatively affect the macro economy, triggering inflation, and raising interest rates and exchange rate appreciation (aid-induced

Dutch disease; see section 4.3.1). Foreign aid in the form of loans raises the problem of debt sustainability. High levels of aid can destabilise the local labour market, since aid increases demand for skilled labour, thus ratcheting up wages (De Renzio 2005:2; and section 4.3.1). A large inflow of aid can swamp the management and institutional capacity of a recipient country, limiting the effective use of aid income.

Absorptive capacity limits the country's ability to take advantage of the increased income. Lack of infrastructure, equipment and staff reduces the recipient's ability to convert aid into the infrastructure and public services that could raise the wellbeing of the population. A sudden increase in aid may be prove unproductive, since the recipient country lacks the capacity to scale up infrastructure and public services in line with the increase in income (De Renzio 2005:2). Poor countries typically have a limited pool of skilled management and technical staff. Better infrastructure and increased training capacity (universities and colleges) take time to develop. Too much aid can cause bottlenecks as the country struggles to deliver on public services (Heller & Gupta 2002:138). For example, an increased health budget means an improved supply of essential medicines, which creates a logistical bottleneck as the health system struggles with warehousing shortages, poor roads, and insufficient personnel to disseminate medicine. Some constraints can be relieved quickly – for example warehousing can be built with aid money – but other constraints such as skilled personnel take time to develop. Aid cannot relieve all bottlenecks, but effective planning, monitoring and evaluation of aid flows can identify measures to gradually remove these constraints (Clemens & Radelet 2003:5). The lack of capacity to manage aid effectively is particularly significant for countries that are decentralised and the provincial and district management are unable to effectively use the increased resources (Heller & Gupta 2002:138). Donor behaviour can also exacerbate a country's ability to absorb additional aid.

Donor behaviour can hinder a recipient's ability to absorb foreign aid efficaciously. The interaction of donors within the recipient country (see section 4.2.2), donor disbursement systems (see section 4.2.3), and the aid system (see section 4.3) in general affect the ability of the recipient country to absorb foreign aid. Donor fragmentation, lack of coordination and numerous donor projects impose burdensome transactional expenditure on the recipient government (see section 4.2.2). High transactional costs rob government officials of their time and distract them from their responsibility of running the country (see section 4.2.2.1). The unpredictability and volatility of foreign aid further impedes the recipient's medium- and long-term planning and investment strategies (see section 4.2.3) (De Renzio 2005:2; Clemens & Radelet 2003:5). Poor planning and low investment reduce the effectiveness of aid. Absorptive capacity and the fact that aid is subject to diminishing returns can result in aid being less effectual, particularly in countries that receive high levels of sustained foreign aid.

5.2.3 AID USED FOR CONSUMPTION

In section 4.2.1 we discussed how donors provide aid to developing countries to achieve a number of objectives, including economic growth and development. The Harrod-Domar and two-gap growth models (see sections 2.2.2, 2.2.3 and 2.2.4) argued that when foreign aid was provided to developing countries, it was based on the assumption that an increase in capital (including aid capital) would result in a rise in investments, which in turn would promote economic growth. Foreign aid was initially intended to supplement domestic savings, but, according to Griffin (1970:102), aid was often used to fund public consumption, rather than productive investment. Public consumption includes spending on health, education, social relief, defence and public administration (Burnside & Dollar 1998b:10). When the recipient government receives foreign aid, it may react to the

increased income by changing state budget allocations to increase public consumption, therefore foreign aid results in increased government spending on consumption rather than productive investment (refer to section 4.3.3 on aid fungibility). Griffin (1970:107), Barro (1991, in McGillivray & Morrissey 2001:30), Arellano et al (2009:100) and Boone (1995:4) found that recipients were using foreign aid to fund public consumption. As Boone (1995:4) points out, 'government consumption rises by approximately three quarters of total aid receipts'. That is, only a small percentage of foreign aid is used for productive investment. Referring back to the growth models and economic theory (see sections 2.2.2, 2.2.3 and 2.2.4) we notice that aid was not being used to fill the savings and investment gaps, and therefore to a degree explains why aid may not have achieved the anticipated growth rates. However, as Feyzioglu, Swaroop and Zhu (1996:27) reminded us, donors are not consistent, and not all donors provide foreign aid solely for the purposes of investments; some donors provide foreign aid specifically for consumption. That is, they supply aid funds for education, health and social welfare expenditure. But is the use of foreign aid for consumption really a bad thing? Aid that is used for public consumption may be supporting very poor households, which will lead to improved social indicators, which in turn may result in long-term growth. Burnside and Dollar (1998b:10) pointed out that large government consumption could be reflecting large expenditure on social welfare, which is helping to reduce poverty and therefore does not constitute the misuse of aid funds.

If foreign aid is being used to fund public consumption instead of investments, or if donors specifically provide a portion of their aid for public consumption, then we can conclude that this portion of the aid capital will not have any impact on growth. But as Burnside and Dollar (1998b:11) point out, the consumption of aid 'might be helping the poor through social expenditures'. We must remember that foreign aid is not given to recipient countries for the single purpose of stimulating economic growth or promoting investment. Donors do

provide a portion of their aid for public consumption. Any impact of foreign aid invested in human capital (health, education and welfare) will take a long time to produce results or impacts on growth (Morrissey (2001:48). Gomanee et al (2003:3) point out that this phenomenon may explain why, although growth has not been spectacular in the developing world, there has been an improvement in social indicators in most developing countries since the 1960s. Globally for example life expectancy at birth was 54.5 years in 1970 and increased to 64.4 in 1997 (Gomanee et al 2003:3). Similarly, in least developed countries, infant mortality rate dropped from 152 per 1 000 live births in 1970 to 97 per 1 000 live births in 2005; and the under-five mortality rate dropped from 245 per 1 000 live births in 1970 to 153 per 1 000 live births in 2005 (UNDP 2008:264). There has been progress in welfare, and aid may have been a contributing factor. As Gomanee et al (2003:3) point out, aid used for public consumption will have no measurable impact on economic growth, but it will contribute to poverty reduction. Therefore, if donors provide aid funds for public consumption, why do we measure the impact of foreign aid against the indicator of economic growth?

If donors are providing aid for consumption, and aid is being measured solely against economic growth indicators, then it is hardly surprising that aid is not performing as expected. Aid cannot be provided for one objective (poverty reduction or social welfare in the form of public consumption)³ and then be measured for its effectiveness against a completely different indicator (economic growth). If recipient countries are using aid for consumption, and if donors are providing a portion of their aid capital for public consumption (poverty reduction and welfare), then there is no real problem, other than a methodological problem, when trying to measure the impact of foreign aid against the sole indicator of economic growth.

Since the mid 1990s, a number of researchers have raised the question of how external variables can contribute to a reduction in the effectiveness of foreign aid. These variables, which are outside the control of the donors and the recipients, include geography, climate, natural disasters and economic shocks, and are discussed in the next section.

5.3 EXTERNAL VARIABLES

Foreign aid does not function in a vacuum, and is influenced by a number of variables, including the actions of donors, recipients and even aid itself. A number of external variables may influence the impact aid has on growth. These include trends in terms of trade, volatile export commodity income, economic shocks, disasters, and possibly even geography and climate (Guillaumont & Chauvet 2001:66). If external variables such as economic shocks or natural disaster have a negative impact on growth and development, they should not be ignored in the measurement and evaluation of the effectiveness of foreign aid, since they influence growth, and, if left unconsidered, can lead to inaccurate conclusions about the impact of foreign aid on growth. In this section we examine shocks (economic and natural), climate and geography to determine the role that these variables play in diluting the ability of foreign aid to have a positive impact of growth and development.

5.3.1 ECONOMIC SHOCKS AND NATURAL DISASTERS

Low-income countries tend to rely on one or two export commodities as their primary source of export earnings – for example copper in Zambia, coffee in Rwanda and aluminium in Mozambique. When low-income countries are exposed to sudden economic shocks, the result is a sharp decline in their export earnings, a shrinking economy, and an escalating balance of payments problem. In Mozambique for example, where aluminium constitutes 67 per cent of export earnings, the economy is vulnerable to fluctuating

commodity prices. In 2008/2009 the price of aluminium tumbled from a high of \$3 067 per ton (June 2008) to a low of \$1 465 (January 2009) (Condon 2009:11). Since the Mozambican economy is dependent largely on the exportation of aluminium, the decline in the aluminium price had a negative impact on the economy. The net effect of this loss of export earnings resulted in a balance-of-payments deficit. By the end of the 2008/9 fiscal year, Mozambique had an additional balance-of-payments deficit of \$160 million. Mozambique had to appeal to the IMF for assistance, and received a bridging loan of \$250 million (Condon 2009:13). Therefore poor countries are hit with a double shock, since they lose valuable foreign exchange (income) and, because of the loss in income, the country is forced to borrow more money to bridge its trade deficits. The additional loans increase the debt burden, further hindering development and growth in poor countries. If the variables described above are not considered in the analysis, foreign aid can appear to have less impact on growth than it was the case.

The economies of many low-income developing countries are susceptible to economic shocks and natural disasters (floods, cyclones or famines). Economic shocks and natural disasters have adverse and negative effects on the economy and therefore on growth. Investment may be discouraged if an economy is perceived to be vulnerable to shocks. If foreign investments decline, or if the country is perceived as high risk for investment, this will have a negative impact on economic growth. Easterly, Kremer, Pritchett and Summers (1993:481) found that shocks to the terms of trade were a significant cause of variations in growth rates. When measuring the impact of foreign aid on growth, researchers use the economic growth indicator as a measure of the effectiveness of foreign aid. However, if shocks or disasters cause a decline in economic growth, this negative influence will be reflected in the calculation of the effectiveness of aid, unless the researcher make allowances for the impact of the shocks in the methodology. This is yet another example of

how variables that have nothing to do with foreign aid can affect economic growth in a recipient country. If the researcher does not consider all possible variables that may affect the relationship between foreign aid and growth, research results may lead to an inaccurate conclusion.

Economic shocks and natural disasters, as we have demonstrated, have a negative impact on investments, policy environment and economic growth. Donors have not used aid effectively to mitigate the negative impact of shocks, and this is a lost opportunity, as indicated above. Ignoring shocks in the model results in inaccurate analysis and conclusions, which may to a certain degree explain why the measurement of the impact of aid on growth and development has been so inconclusive and controversial. The methodology, as we discussed in sections 3.6.2 to section 3.6.6, is inappropriate. The consideration of economic shocks and natural disasters reinforces the argument, presented in section 3.6.6, that calls for a discontinuation of cross-country regression analysis and a switch to the use of country-specific case studies, as discussed in section 3.6.7. A country-specific case study will enable the researcher to include the impacts of economic shocks and natural disasters in calculating the impact of aid on growth and development for the country under review. Recent research indicates that climate and geography, like economic shocks and natural disasters, influence the ability of aid to have a positive impact on growth and development.

5.3.2 CLIMATE AND GEOGRAPHY

In recent studies, researchers have been evaluating the impact of a number of variables as we have discussed in the preceding two chapters. Some researchers, in an attempt to explain why foreign aid has not had the impact suggested by modernisation theories and

economic models (see sections 2.2.1, 2.2.2 and 2.2.4 respectively), have turned to determining whether the climate and geography of a aid-recipient country influence the effect of aid on growth and development. In this section we will evaluate a sample of the studies that consider these variables in order to determine their relevance to measuring the impact of foreign aid on growth and development.

Dalgaard et al (2004:192) found that if they allowed for a climate variable in their model, then their results indicated that foreign aid appeared to be less effective in the tropics. A possible explanation presented by Dalgaard et al (2004:192) was that climate may have an influence on productivity of the country. Similarly Sachs and Warner (1997, in Temple 1998:310) found that if they used a geographic variable in their model, aid appeared to be less effective in certain locations. They noted that many African countries are land locked, have tropical climates and specialise in exporting raw materials and primary goods, for example copper, coffee and aluminium. These factors collectively could be contributing to slow growth in Africa. But, as Gounder (2001:1017) rightly points out, there may be a number of plausible reasons that growth may be higher outside the tropics but the rationale for the effectiveness of aid outside the tropics or its ineffectiveness in the tropics is unclear. Similarly, in agreement with Gounder and refuting the argument that geography may influence the effectiveness of foreign aid, Rajan and Subramanian (2005:5) concluded in their study⁴ that there was 'virtually no evidence that aid works better in better policy or institutional or geographical environments'. There is some indication that geography and climate may influence the impact of foreign aid on growth and development, but it could be equally classified as anecdotal evidence, and is not relevant to the discussion, other than to serve as further proof that the use of country-specific case studies, as we argued in section 3.6.7, is a more appropriate methodology.

This discussion has reinforced the arguments presented in sections 3.6.2 to 3.6.6 that cross-country regression analysis may not be the most appropriate methodology for measuring the impact of aid on growth and development. The discussion reinforces the argument that we presented in section 3.6.7. That is, country-specific case studies may be the most appropriate method to measure the impact of foreign aid on growth and development. Using the case study methodology will allow researchers to include such variations as climate and geography in their analysis.

5.2 CONCLUSION

The recipient country's environment, institutions, and ability to absorb foreign aid can contribute to a reduction of the impact of foreign aid on growth and development. Additionally, external variables outside the control of recipient countries reduce the impact of foreign aid. In this chapter we demonstrated that the recipient environment, neoliberal economic policy and external variables contribute to the reduction of the impact of foreign aid.

The consensus, as discussed in section 5.2.1, is that the recipient's policy environment is important to growth, and a poor policy environment could reduce the impact of aid on growth and development. While we accept that the recipient's policy environment is an important variable for foreign aid, it raises the question of what constitutes a 'good policy environment'. If foreign aid is provided to only countries with good policy – which in donor terms means neoliberal economic policy – it has been shown in section 5.2.1.1 that neoliberal economic policy may not be the most appropriate growth path for developing countries to follow. From the evidence presented in section 5.2.1.1, the adoption of good neoliberal policies may well condemn aid-recipient countries to a slower, less effective

growth path. Since donors promote neoliberal economic policies, which we have demonstrated may be the wrong policies for growth and development, we therefore argue that donors have created a system in which the economic policies they are promoting may be hindering growth and industrialisation in aid-recipient countries (Reinert 2007:xxvii). Therefore, aid is less likely to have a positive impact on growth and development owing to the enforced adoption of neoliberal economic policy.

The capacity of the recipient country can affect the ability of foreign aid to make a positive impact on growth and development. If the recipient country does not have a sound policy environment (however policy is defined), has a weak system of governance, and the state institutions lack the ability to absorb aid effectively, then it is likely that foreign aid will not produce the expected results in terms of economic growth and development. If donors scale up their aid, the increase of aid inflows does not automatically translate into increased growth and development. An increase in aid inflow may be beyond the recipient's capacity to absorb additional aid effectively. Therefore, the problem is not foreign aid, but the capacity of the recipient to use aid effectively and the ways in which the recipient uses aid income in terms of investment and consumption. In an evaluation of the impact of foreign aid on growth and development the methodology used by the researcher must take cognisance of the absorptive capacity of the recipient countries.

The early growth models (see sections 2.2.2, 2.2.3 and 2.2.4) suggested that foreign aid increased growth by filling the savings, investment and foreign exchange gaps, but donors do not provide foreign aid solely for investment. If donors provide aid for consumption, and if the impact of foreign aid is being measured solely against economic growth indicators, then it is hardly surprising that foreign aid is not performing as expected. Foreign aid cannot be provided for one objective (poverty reduction or social welfare in the form of

public consumption) and then measured for its effectiveness against economic growth, which is a completely different indicator. If recipient countries are using aid for consumption, and if donors are providing a portion of their aid capital for public consumption (poverty reduction and welfare), then there is no real problem other than a methodological one when trying to measure the impact of foreign aid against the sole indicator of economic growth.

The ability of aid to stimulate growth and development depends on donor motives, donor behaviour, the management of aid itself and, as discussed in this chapter, the specific conditions in each recipient country. The environment (policy, institutions, governance) in the recipient country and the behaviour of the recipient government influence the impact of foreign aid on growth and development. In this chapter we have seen that there is evidence that the policy environment (however defined), the quality of governance, the absorptive capacity of the recipient country, and the use of aid to fund public consumption all contribute to some degree to the dilution of aid's ability to have a positive impact on growth and development. But we have also repeatedly argued that the current methodology (namely cross-country regression analysis – see section 3.6.3) used to measure aid effectiveness is questionable. The use of foreign aid for public consumption (see section 5.2.3) in particular highlights the problems with the way in which the effectiveness of foreign aid is being measured. Donors do provide a portion of foreign aid specifically for public consumption, but aid effectiveness is being measured solely against the indicator of economic growth.

In this chapter we have also seen that the recipient environment, and the particular characteristics of the recipient country play a role in determining the ability of aid to influence growth and development. Each developing country has specific characteristics

and conditions, which are not stagnant and change with time. This is another important consideration that supports the argument that country-specific case studies may be a more appropriate methodology for measuring the impact of foreign aid (see section 3.6.7). Furthermore, economic shocks and natural disasters, as we demonstrated in section 5.3.1, have a negative impact on economic growth. Similarly there is some indication, as discussed in section 5.3.2, that geography and climate may influence the impact of foreign aid on growth and development. The consideration of economic shocks and natural disasters reinforces the methodological argument presented in section 3.6.6 calling for a discontinuation of cross-country regression analysis and a switch to country-specific case studies, as discussed in section 3.6.7. Using a country-specific case study as we have argued in section 3.6.7, will enable the researcher to include the impacts of economic shocks and natural disasters in the calculation of the impact of aid on growth and development for the recipient country under review.

NOTES

¹ Collaborating studies include Durbarry et al (1998:17), World Bank (1998:2), Dollar and Easterly (1999:546), Lensink and White (2000:15), Collier and Dollar (2001:1800), (2001:1), Collier (2002:21), Dollar and Kraay (2002:219), Burnside and Dollar (2004:784), and Collier and Dollar (2004:268)

² Donors forbid recipients to use these strategies.

³ Or to support a donor agenda.

⁴ Rajan and Subramanian (2005:14) test Dalgaard et al's (2004) conclusion on the impact of foreign aid being conditional on geography. Rajan and Subramanian (2005:16) find that in one model construction the aid-geography interaction is significant, suggesting that aid is more effective outside the tropics. However, if Rajan and Subramanian change the specification just slightly, then the aid-geography relationship returns as insignificant, meaning that there appears to be a relationship between aid and geography, but the relationship is unclear.

CHAPTER 6: SUMMARY AND CONCLUSIONS

6.1 INTRODUCTION

The study is a literature review that evaluates the impact of foreign aid on growth and development in aid-recipient countries. The study demonstrated how economic theory influenced the allocation of foreign aid, and ~~cautiously~~ concluded that foreign aid has no impact on domestic savings and investments, and appears to have only a slight positive impact on growth and development. Furthermore, the study demonstrated that foreign aid is used to serve the interests of the donors as much as it is used for growth and development in underdeveloped countries. In addition, the study uncovered a number of important variable clusters, including donor actions, aid inflows, recipient actions and environment; and external factors that contribute in varying degrees to reducing the impact of foreign aid on growth and development. Finally, the study consistently demonstrated that the use of cross-country regression analysis is not an appropriate methodology for measuring the impact of aid on growth and development and recommends that country-specific case studies be used as an alternative methodology for evaluating the effectiveness of foreign aid. In the following discussion, the main arguments and findings of each chapter will be summarised. This will be followed by a conclusion and recommendations.

6.2 SUMMARY OF THE STUDY

The study provided a theoretical framework of the way in which modernisation theory, development economics and global economic trends have influenced the allocation of foreign aid. A careful analysis of the literature revealed that the measurement of the impact

of foreign aid on growth and development is a complex process, fraught with contradiction and ambiguity. The study also revealed that a number of variables affect the impact aid may have on growth and development. Finally, the study consistently demonstrated that the current methodology used to measure the impact of foreign aid on growth and development is not appropriate, and that country-specific case studies are a more suitable alternative for measuring the impact of foreign aid on growth and development.

6.2.1 THEORETICAL FRAMEWORK OF THE STUDY

In chapter 2 we tracked the evolution of development economic theory in order to set the theoretical framework for the study. The narrative traced the evolution of development economic theory and the role of aid from the 1950 through to the early 2000s, drawing out the main concepts and the ways in which they have influenced the allocation of foreign aid.

Section 2.2.2 discussed how foreign aid emerged in the late 1940s, based on the optimistic view that it could promote development and growth in underdeveloped countries simply by providing developing countries with capital to fill their savings and investment gaps. In the 1950s, as discussed in section 2.2.2, the dominant growth model that influenced the allocation of foreign aid was the Harrod-Domar model. In the 1960s, as discussed in section 2.2.4, the two-gap model identified a second gap, namely the foreign exchange gap, as a further hindrance to growth. It was optimistically thought that foreign aid could fill these gaps, and there was a sincere belief that governments in developing countries would plan and use aid effectively. However, aid did not meet expectations, and by the early 1970s, as discussed in section 2.2.6, poverty was increasing, and many developing countries were experiencing declining growth.

The discussion in section 2.2.6 demonstrated that by the 1970s it was evident that modernisation and the concepts of a big push, trickle-down effect and take off to growth were irrelevant in most developing countries. The 1970s ushered in the transition from macro economic urban-biased industrialisation to rural-focused IRD and BNA approaches to development (see section 2.2.6). In the 1970s aid was increasingly targeted towards the rural poor, who until the early 1970s were largely neglected by aid. Aid, as discussed in section 2.2.6, was then provided to developing countries as a 'project package', instead of the large capital investments of the 1950s and 1960s. But even this strategy produced dismal results.

In the 1980s, as discussed in section 2.4 and as demonstrated in section 2.3.2, the ensuing debt crisis resulted in the development model switching back once again to a macro economic growth focus, but this time with the introduction of stringent SAPs, managed by the IMF and World Bank. The 1980s was the lost decade of development, and poverty alleviation programmes were replaced by neoliberal economics in the form of SAPs (see section 2.4.2). Foreign aid was the tool used to underwrite the 'forced' implementation of neoliberal economics in many recipient countries. Developing countries were compelled to 'put their houses in order' through tough SAPs and conditionality. Furthermore, as discussed in section 2.3.2, foreign aid was used to ensure that developing countries continued to service their debts, lest the debt crisis spilled over into the rich world and undermined their economies.

The 1990s, as discussed in section 2.5.1, continued to be dominated by neoliberalism and SAPs. In the early 1990s there was significant reflection on the East Asian miracle countries and the development models used by countries such as South Korea, Taiwan and Singapore. But the East Asian crisis in 1998 gave rise to a reappraisal of the various

models of development. The Post Washington Consensus began to emerge in the early 2000s as a response to the failures of SAPs and the economic disasters in Eastern Europe, Russia and East Asia. It focused on getting fundamental government principles right, and acceptance that the state did have a role to play in development, but maintained a strong belief that development must be based on free-market principles (neoliberalism still dominated). In the 1990s, the questions of policy, governance and institutional capacity became increasingly significant. By the early 2000s, as discussed in section 2.5.2, aid allocations, following the trends in development and economic theory, began to shift from ex-ante conditionality (used in SAPs) to ex-post conditionality. Donors increasingly channelled their aid to countries that were reforming their economic policies along the neoliberal model of free markets. Chapter 2 demonstrated how modernisation theory, development economics and economic trends in the world have influenced the allocation of foreign aid to recipient countries.

6.2.2 ANALYSIS OF THE AID EFFECTIVENESS LITERATURE

In chapter 3 the study showed that, despite substantial investment, foreign aid has not produced the anticipated results in terms of growth or development. Measuring the impact of foreign aid was an important undertaking, as scholars, donors and policy makers grappled with the problem of figuring out why aid was not having the anticipated impact on growth in developing countries. However, after nearly 50 years of study, there is still no conclusive evidence that foreign aid has had any positive impact on savings and investments, and appears to have had only a slight positive impact on growth and development in aid-recipient countries.

6.2.2.1 IMPACT OF FOREIGN AID ON SAVINGS AND INVESTMENTS

From our discussion in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) we found that foreign aid does not have any impact on domestic savings. Furthermore, in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) we found that foreign aid does not appear to have had any significant impact on investments in recipient countries, although this is not conclusive. If we refer back to modernisation theory (section 2.2.1) and the early growth models (section 2.2.2, section 2.2.3 and section 2.2.4), we conclude that foreign aid did not fulfil its objective of filling either the savings or the investment gaps. Based on the logic of the Harrod-Domar (see section 2.2.2) and two-gap models (see section 2.2.4), we argue that foreign aid has not fulfilled the promise of modernisation theory to stimulate the economic take-off in recipient countries (see sections 2.2.1).

6.2.2.2 IMPACT OF FOREIGN AID ON GROWTH AND DEVELOPMENT

The literature is inconclusive about the impact of foreign aid on growth. However, based on the analysis in sections 3.2.1, 3.3.1, 3.5.1 and 3.6.1, we can **cautiously** assume that aid does appear to have a slight positive impact on growth. During the first phase (1950–1975 in section 3.2.1), we concluded, although with some caution, that foreign aid had little or no impact on growth. The second phase (1976–1995 in section 3.3.1) was somewhat more optimistic, and we found that foreign aid appeared to have a slight positive impact on growth. In the third phase (1996–2003, in section 3.5.1) we found that the evidence appeared to continue to support the finding that foreign aid has a slight positive impact on growth and development. However, this positive conclusion is backed by little robust or conclusive evidence; it merely indicates the trend that foreign aid may be having on growth. The fourth phase (2004–2010, in section 3.6.1) continued to support the slight positive aid-growth conclusion of the latter two phases. Therefore summarising the impact of foreign aid on growth we can **cautiously** conclude that foreign aid does appear to have a

slight positive impact on growth and development, but the evidence is not robust. The study also found that the impact foreign aid had on growth was dependent on a number of important variables.

6.2.3 VARIABLES THAT REDUCE THE IMPACT OF FOREIGN AID

Researchers, in their attempts to determine the impact of aid on growth, began to consider other variables that might be influencing it. The literature, as discussed in sections 3.2.2, 3.3.2 and 3.5.2, revealed a number of important variables that influenced the effect of aid on growth. These variables were grouped into four categories: (1) donor variables; (2) impact of aid on recipient country; (3) recipient environment and actions; and (4) external factors. The variables are important for two reasons. First, they indicate how complex and messy the relationship between aid and development really is. Second, the variables demonstrate that aid does not act in isolation. If there are so many important variables, then it can be argued that each variable must be included in the models used to measure the impact of foreign aid on growth. Therefore trying to attribute a country's growth solely to the provision of foreign aid is questionable. If aid is not the only factor influencing a country's growth, then measuring the impact of aid against the indicator of growth is also debatable.

6.2.3.1 DONOR MOTIVES FOR GIVING FOREIGN AID

Foreign aid, as discussed in section 4.2.1, is provided to developing countries to serve the donor's own political, strategic and economic agenda, and is seldom provided purely to meet the needs of recipient countries. If foreign aid is provided to serve donor objectives, we question the inappropriateness of measuring the impact of foreign aid against economic growth indicators.

Since donors use foreign aid to serve their own objectives, we found, as expected, a proliferation of donors in recipient countries (section 4.2.2). Because there are too many donors providing aid through too many projects to too many countries, we found duplication and inefficiency in the provision of foreign aid (section 4.2.2). The high number of donors in recipient countries results in high transaction costs, the creation of parallel structures, and even the draining of skilled officials out of government service.

Furthermore, as we pointed out in section 4.2.3, foreign aid is unpredictable and volatile, which means that recipient governments are unable to make productive investments, thus further reducing the impact of foreign aid on growth and development. In a number of countries donors are providing too much aid. Since aid is subject to diminishing returns (see section 4.2.4), the impact of aid on growth and development is further reduced. Donors, through their actions, make the aid system inefficient. Therefore, we argue, the variables discussed in sections 3.2.2, 3.3.2 and 3.5.2 must be included in any methodology that attempts to measure the impact of foreign aid on growth and development. This point is important, since these variables dilute the effect of aid on growth and therefore should be taken into consideration when evaluating the impact of foreign aid on growth and development. But donors are not the only problem with foreign aid; even the flow of aid capital into a recipient country can reduce the impact of aid on growth and development.

6.2.3.2 AID VARIABLES

The flow of foreign aid into developing countries, as demonstrated in section 4.3, can further reduce the impact of aid on growth and development. Aid-induced Dutch disease, as discussed in section 4.3.1, produces a negative impact on the economy; and leads to an overvaluation of the local currency, a subsequent decline in local industry; and

reduced investment in local manufacturing. Export products from the developing country become uncompetitive on the global market, and subsequently their exports decline. These four problems are in direct contradiction to the growth models discussed in sections 2.2.2 and 2.2.4. Therefore, foreign aid is counterproductive in the recipient's economy. In addition, foreign aid, as demonstrated in section 4.3.2, has a tendency to decrease the incentives of recipient governments to scale up domestic tax collection, improve their domestic savings, make productive investments, and exercise budgetary discipline. When too much foreign aid is readily available, it is easier for recipient governments to request more aid than to make the tough decisions needed to develop strong disciplined state institutions that live within their budget. Aid, as discussed in section 4.3.3, is at least partially fungible, therefore further reducing the impact of aid on growth. The degree of fungibility depends on the characteristics and environment of the recipient country; the type of aid that donors provide (for example direct budget support, sector aid, loans, grants or projects) and the levels of aid dependency of the recipient country. When aid flows into a recipient country, its impact on growth and development will to a degree also depend on the recipient's environment and how the recipient country used the aid capital.

6.2.3.3 RECIPIENT ENVIRONMENT AND ACTIONS

The recipient country's environment, institutions and ability to absorb foreign aid can contribute to a reduction in the influence of foreign aid. We demonstrated in section 5.2 that the recipient environment, and the enforcement of neoliberal economic policy contribute to a reduction of the impact of foreign aid.

As discussed in section 5.2.1, consensus in the literature is that the recipient's policy environment is important to growth. However, there are two caveats with this position. First, poorly governed countries should not receive less aid – they should receive more –

but the aid should be disbursed through adapted or different strategies. Second, while we accept that the recipient's policy environment is an important variable for foreign aid, an important question is what would be considered a good policy environment. If foreign aid is provided to only countries with good policy, which in donor terms means neoliberal economic policy, then, as demonstrated in section 5.2.1.1, neoliberal economic policy may not be the most appropriate growth path for developing countries to follow.

6.2.3.4 IMPOSED NEOLIBERAL ECONOMIC POLICY

From the evidence presented in section 5.2.1.1, the adoption of neoliberal policies may well condemn aid-recipient countries to a slower less effective growth path. Furthermore, we demonstrated that the neoliberal policies are the wrong policies for growth and development. Therefore, as we argued in section 5.2.1.1, donors have created a system in which the economic policies they are promoting may be hindering growth and industrialisation in aid-recipient countries. Therefore we conclude that, first, donors use aid to serve their own interests (as discussed in section 4.2.1). Second, through their inappropriate actions (see sections 4.2.2 4.2.3 and 4.2.4) and finally through the promotion of neoliberal economic policy (as discussed in section 5.2.1.1), donors have created a foreign aid system that is unlikely to have any significant positive impact on growth and development. However, the recipient country also influences the impact of foreign aid on growth and development.

The capacity of the recipient country to use aid effectively can affect the ability of foreign aid to have a positive impact on growth and development. In sections 5.2.1 and 5.2.2 we pointed out that if the recipient country does not have a sound environment, has a weak system of governance, and the state institutions lack the ability to absorb aid effectively, then it is likely that aid will not produce any significant positive results. Under these

circumstances, the problem is not foreign aid, but the capacity of the recipient to use aid effectively. Therefore any evaluation of foreign aid must take cognisance of the recipient country's environment, its institutions and absorptive capacity.

6.2.3.5 THE CONSUMPTION OF FOREIGN AID

Not all donors provide foreign aid solely for the purposes of investment or macro economic development (see section 5.2.3). Some donors provide at least a portion of their aid specifically for public consumption (education, health and social welfare). Aid used for public consumption may be supporting very poor households, which will in turn leads to improved social indicators that may result in long-term growth. If donors provide a portion of their aid for public consumption, why do we measure the impact of foreign aid only against the indicator of economic growth? If recipient countries are using aid for public consumption and if donors are providing a portion of their aid capital for public consumption (poverty reduction and welfare), then there is no real dilemma, other than a methodological problem that tries to measure the impact of foreign aid against the sole indicator of economic growth. This argument also supports our case that the measurement of foreign aid must move away from cross-country regression analysis and researchers should adopt a more appropriate methodology, such as the country-specific case study that we proposed in section 3.6.7. Finally, some variables that influence foreign aid are outside the control of either the donors or the recipients.

6.2.3.6 EXTERNAL VARIABLES

Recent research has questioned the influence that economic shocks, disasters, climate and geography may have on foreign aid, growth and development. In section 5.3.1 we demonstrated that economic shocks and disasters also have a negative impact on aid's contribution to economic growth. Donors have not used aid effectively to mitigate the

negative impact of shocks, and this is a lost opportunity, as indicated above. Furthermore, as discussed in section 5.3.2, there is some indication that geography and climate may also influence the impact of foreign aid on growth and development. Therefore, as we have argued throughout this chapter, the evaluation of the impact of aid must take all variables into consideration. Ignoring variables, including external variables, means that the calculation of the effect of aid on growth will be inaccurate. These inaccuracies may explain to a degree why the measurement of the impact of aid has been so inconclusive and controversial. The methodology currently in use, as we discussed in section 3.6.3 and section 3.6.6, is inappropriate and thus reinforces our argument, presented in section 3.6.6, calling for a discontinuation of cross-country regression analysis. We proposed in section 3.6.7 that country-specific case studies might be a more appropriate methodology. Using a country-specific case study will enable the researcher to include the impacts of all variables in the evaluation of the effectiveness of aid.

6.2.2.3 METHODOLOGY QUESTIONED

The increasing number of variables led us debate the value of cross-country regression analysis as a methodology for measuring the impact of aid on growth and development. From our analysis in sections 3.6.3 to 3.6.6, we questioned the value of cross-country regression analysis as a tool for measuring the impact of aid on growth and development. Cross-country regression analysis is doubted in terms of econometric formulae construction (section 3.6.4), data construction and sampling procedures (section 3.6.5). The methodology amounts to a generalisation of the impact of foreign aid, measured across a large number of countries, which tends to average out data differences between countries. Cross-country regressions must therefore be supplemented by other methods of analysis or replaced, as we have argued in section 3.6.7, by a more appropriate methodology, such as country-specific case studies. We pointed out in section 3.6.7 that

evidence from specific programme and country case studies may provide a better understanding of the impact of foreign aid. In section 3.6.7 we presented a number of arguments that supported the rationale of using a country-specific case study to measure the impact of aid on growth. Case studies, rather than using data from multiple countries and over long periods, evaluate the impact of foreign aid, based on the data from one country. The case study analysis is therefore more focused and not subject to the complexities of using data from over 100 countries. Case studies have the advantage that they can take into consideration the particular characteristics, variables and environment of individual country, rather than treating all countries, aid and donors as homogenous groups that act in uniform ways. Country-specific case studies offer enhanced insight into the impact of aid on growth and development.

But even if researchers figure out a better methodology for measuring the impact of foreign aid on growth, there is still the important question of why we measure the effectiveness of foreign aid against the indicators of economic growth? Donors provide aid, as we discussed in section 4.2.1, to serve their own objectives. Economic growth and development in the recipient country can be seen as a secondary objective of foreign aid. If donors provide aid to achieve their own economic, political and strategic objectives, then, as we argued in section 4.2.1.5, foreign aid's performance cannot be measured and judged solely against the indicators of economic growth. Similarly, in section 5.2.3 we pointed out that some donors provide at least a portion of their aid specifically for public consumption. If donors provide a portion of their aid for public consumption, why do we measure the impact of foreign aid only against the indicator of economic growth? If donors are providing aid to serve their own objectives (see section 4.2.1) and for public consumption (see section 5.2.3), and if aid is measured solely against economic growth indicators, then it is hardly surprising that foreign aid is not performing as expected. Aid

cannot be provided for one objective (donor objectives or public consumption) and then measured for its effectiveness against completely different indicators (for example economic growth).

Based on the evidence gleaned from more than 50 years of research, we **cautiously** conclude that foreign aid has no impact on domestic savings; no impact of recipient investments; and only has a slight positive impact on growth and development. But the evidence for this positive aid-growth conclusion is fragile. While the question 'Does aid work?' remains largely unclear, the methodology used to measure foreign aid is questionable. Aid does not function in isolation, and many variables that influence its impact on growth and development. These variables are important since they should be considered in any attempt to measure the impact of foreign aid on growth and development. Finally, we question the rationale of measuring aid against the indicator of economic growth since aid serves the donor's agenda as much as it does the recipient's need.

6.3 CONCLUSION AND RECOMMENDATIONS

In this study we found that, despite substantial investment, foreign aid has not produced the expected results in terms of growth or development. After nearly 50 years of research, there is still no conclusive evidence that foreign aid has had any significant impact on savings, investments and growth. We saw from our discussion in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) that foreign aid does not have any impact on domestic savings. Furthermore, in section 3.2.1 (and table 3.1) and section 3.3.1 (and table 3.2) we found that foreign aid does not appear to have had any significant impact on investments in recipient countries, although this is not conclusive.

The literature is ambiguous about the impact of foreign aid on growth, but we can cautiously conclude that aid does appear to have a slight positive impact on growth. But the magnitude of the impact is dependent on a number of variables, and therefore much harder to determine. In addition, the evidence for this positive aid-growth conclusion is fragile, and leaves us questioning, first, the role that other variables may have had on foreign aid; second, the methodology used to measure aid effectiveness; and finally the rationale of measuring the impact of aid solely against economic growth indicators.

In this concluding chapter, we have demonstrated that donor motives and the variables such as donor actions, recipient environment, the consumption of aid, external factors, and even the inflow of foreign aid, all reduce the impact of foreign aid on growth and development. Therefore, based on the evidence presented in this study, it is argued that every study that attempts to measure the impact of foreign aid must, at the very least, take all these variables into consideration. This means that the methodology used must take cognisance of donor variables (donor fragmentation and proliferation, unpredictability and volatility of aid income and diminishing returns), aid variables (Dutch Disease; incentives to tax, save and invest; and the fungibility of aid), the recipient environment and characteristics (policy environment, absorptive capacity and the use of aid for consumption) and external variables (shocks, disasters, climate and geography). These constitute a significant number of variables for a researcher to use in the construction of a model to be used in a cross-country regression analysis. The consideration of the variables that we have presented in this study demonstrated that the current methodology, namely cross-country regression analysis, is not appropriate for measuring the impact of foreign aid. Two further important considerations support the argument that foreign aid should not be measured solely against the indicator of economic growth. First, the use of

foreign aid for public consumption (see section 5.2.3) particularly highlights the problems with the way in which the effectiveness of foreign aid is being measured and, second, donors use foreign aid to serve their own objectives. Growth in recipient countries may be a secondary objective of foreign aid.

In section 5.2.3 we pointed out that donors often provide a portion of their foreign aid specifically for public consumption. Aid effectiveness, however, is measured solely against the economic growth indicator. Aid provided for public consumption will have an impact on growth only in the longer term. This effect is particularly hard to quantify and measure. Therefore aid that is provided for public consumption will not be reflected in economic growth indicators and should not be included in any calculation measuring the impact of foreign aid against economic growth indicators. One might argue that the researcher should discount any foreign aid provided for public consumption. However, this will be an extremely complex task since cross-country regressions typically consider 100 plus countries and usually over time spans of 20 to 40 years.

Furthermore, as we pointed out in section 4.2.1, because donors use foreign aid to serve their own agenda, this raises serious doubt about the rationale of measuring the impact of foreign aid solely against economic growth indicators. Foreign aid, as demonstrated in section 4.2.1, is provided to developing countries to serve not only the needs of recipient countries, but also the donor's political, strategic and economic objectives. We therefore argued that donors provide foreign aid to serve their own objectives, and that a secondary objective of aid is economic growth and development in the recipient country. If donors provide aid to achieve their own economic, political and strategic objectives, then one cannot expect foreign aid's performance to be measured and judged solely against economic growth indicators. If foreign aid is used to serve the economic, strategic,

influence and political agenda of the donors, we cannot expect aid to be effective when measured against economic growth. The arguments presented above reinforce the recommendation that foreign aid must be measured using country-specific case studies rather than cross-country regression analysis.

A number of arguments support the rationale of using a country-specific case study to measure the impact of aid on growth. Case studies, rather than using data from multiple countries and over long periods, evaluate the impact of foreign aid based on the data of that specific country. The case study analysis is therefore more focused, and not subject to the complexities of using data from more than 100 countries. In addition, case study analysis allows the researcher to focus on the specific characteristics of the country under evaluation. Next, case studies have the advantage that they can take into consideration the particular characteristics and environment of individual countries rather than treating all countries, aid and donors as homogenous groups that act in uniform ways. Finally in a country-specific case study the researcher will be able to disaggregate foreign aid into at least two categories: (1) aid for growth; and (2) aid for public consumption (welfare). In this way it may be possible to measure the impact of foreign aid against economic growth and welfare indicators. But all this measuring of the impact of aid on growth and development may be redundant anyway, since donors use foreign aid to serve their own interests first. Therefore, measuring the performance of foreign aid that is used to primarily to serve the interests of the donor country, instead of growth in a recipient country, does not make sense, since aid is used to serve a donor agenda and therefore cannot and should not be measured against growth in recipient countries.

Having taken all these facets into careful consideration, we now make these recommendations:

- Donors should reduce the number of countries and projects in which they are engaged.
- By doing so, they will decrease their transactional costs in recipient countries.
- They will diminish the skills drain and strengthen the institutional and governance capacity of the recipient country.
- Donors should limit their aid inflows so that they match the capacity of the recipient country to absorb the aid inflows.
- Donors should develop a long-term exit strategy by building the institutional and state capacity as they slowly withdraw their aid.
- Donors should separate their foreign policy and political objectives from foreign aid.
- The aid delivery mechanism must be improved in order to match it to the recipient country's capacity to absorb aid.
- The impacts of Dutch disease should be more carefully managed.
- The methodology used to measure aid effectiveness must take into account that aid serves a number of objectives, and therefore should be measured against the indicators of those objectives and not solely against the indicator of economic growth.
- Cross-country regression analysis should be replaced with individual country case studies or sector specific studies.

In conclusion, to accurately measure the impact of aid on a developing country is probably impossible. Aid is but one factor in the complex process of economic growth and development. At the beginning of the study, the question 'Does foreign aid work?' was posed. Since the early 1950s, researchers have been analysing and calculating the effectiveness of foreign aid, trying to answer this important question. The consensus in the

literature is that 'Yes, foreign aid does appear to have a slight positive impact on growth', but this conclusion is not irrefutable. Many variables influence growth and development in a developing country, and it is extremely difficult to measure the effectiveness of foreign aid through the use of cross-country regression analysis. The methodology is too generalist, and treats foreign aid as a homogenous entity that works equally in all countries in all types of environment and across all periods, which of course it does not. There is an urgent need to shed the burden of cross-country regression analysis and switch to individual country or sector-specific case studies. When doing a country case study, there is still a need for robust statistical analysis, and many of the problems highlighted in this study will apply. Researchers, however, will have an easier task of detangling the unique development issues that are specific to the country under evaluation. There is an urgent need for experienced researchers and economists to develop a more appropriate methodology that can measure and assess the impact of foreign aid by evaluating the impact of foreign aid on an individual country. To answer the research question: Yes, aid does have a positive impact on growth and development, but there is an urgent need to reform the aid system and develop a new methodology for measuring the effectiveness of foreign aid.

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ANNEXURE

REFERENCE TABLE OF STUDIES COVERING PHASE 3 AND 4

Authors	Year	Page	Conclusions
Boone	1996	27	Aid has no impact on economic growth or investment
Amavilah	1998	694	German aid has small short-term positive impact on growth in Namibia
Durbarry et al	1998	17	Aid has positive impact on growth in a good policy environment but it is not dependent on policy and aid is subject to diminishing returns
Guillaumont & Chauvet	2001	87	Aid impact on growth is not necessarily positive and depends on climatic conditions in recipient countries
Lensink & Morrissey	1999	22	Aid has a positive impact on economic growth but this impact is dependent of the predictability of aid receipts
Svensson	1999	293	Aid has a positive impact on growth in more democratic countries while in less democratic countries aid is used to support patronage and wasteful government consumption
Burnside & Dollar	2000	847	Aid has positive impact on economic growth but only in countries with good policies
Hansen & Tarp	2000	122	Aid has positive impact on growth irrespective of the policy environment
Lensink & Morrissey	2000	45	Aid has a positive impact on growth through the level of investment
Lensink & White	2000	13	Aid has a positive impact on growth but question the good policy environment (of Burnside & Dollar (2000))
Collier & Dehn	2001	33	Aid has a positive impact on economic growth in countries with good policies
Collier & Dollar	2001	1800	Aid increases the benefits of good policy and good policy increases the impact of aid so good policy and aid has a positive impact on growth and poverty reduction

Authors	Year	Page	Conclusions
Dalgaard & Hansen	2001	37	Aid has positive impact on growth with diminishing returns irrespective of the policy environment
Gounder	2001	1009	Aid has positive impact on economic growth (Fiji case study)
Hansen & Tarp	2001	566	Aid has a positive impact on growth with diminishing returns and irrespective of policy environment
Hudson & Mosley	2001	1034	Aid has a positive impact on growth with diminishing returns and irrespective of policy environment
Lensink & White	2001	61	Aid has a non-linear positive impact on growth, is subject to diminishing returns and aid is productive irrespective of the policy environment
Lloyd, Morrissey & Osei	2001	24	Aid have a positive impact on growth in Ghana since mid 1980s which partly was by policy reform and finance investment
Lu & Ram	2001		Aid has a positive impact on growth with diminishing returns and irrespective of policy environment (in McGillivray 2006:1046)
Morrissey	2001	38	Aid has a positive impact on growth and this is not conditional on policy (irrespective of the policy environment)
Collier & Dollar	2002	1496	Aid has positive impact on growth but only in a good policy environment
Collier & Hoeffler	2002	12	Aid has more positive impact on growth in post conflict countries
Maurotas	2002	45	Project and programme aid seem to have a negative impact on growth in India
Chauvet & Guillaumont	2003	15	Aid has a positive impact on economic growth in countries with good policies ('aid appears simultaneously more efficient when present policy is good')
Dayton-Johnson & Hoddinott	2003	22	The aid/growth relationship in a good policy environment is fragile except when considering the impact of aid in Sub-Saharan Africa
Dayton-Johnson & Hoddinott	2003	22	Aid has a positive impact on growth. The good policy environment is only relevant for aid channelled to sub-

Authors	Year	Page	Conclusions
			Saharan Africa
Ehrenpreis & Isenman	2003	12	Aid has positive impact on growth in post conflict situations and its impact differs across countries depending on conditions they face
Gomanee et al	2003	15	Aid on average has a positive impact on growth irrespective of policy environment and they find there are no diminishing returns
Islam	2003		Aid has a positive impact on economic growth in countries with good policies
Kosack	2003	11	Aid on average has no impact on quality of life but is more effective in democratic societies and possibly harmful in autocracies
McGillivray	2003	7	Aid has a positive impact on growth, is subject to diminishing returns and seems to be most effective in countries with good policy, good governance. Aid works best in post conflict, during shock periods and in politically stable countries
Burnside & Dollar	2004	19	Aid has a positive impact on economic growth in countries with good policies and dependent on institutional quality
Clemens, Radelet & Bhannani	2004	37	Aid has a significant positive short term impact on growth
Collier & Dollar	2004	255	In their poverty efficient aid allocation used the World Bank (CPIA) index instead of B&D (2000) policy measures and again. Aid has a positive impact on growth and poverty reduction and find the aid-policy relationship as significantly positive
Dalgaard, Hansen & Tarp	2004	212	In many countries aid has had a positive impact on growth with diminishing returns, there is a weak aid/policy relationship and aid seems to be less effective in the tropics
Easterly, Levine & Roodman	2004	775	Did not find aid has a positive impact on economic growth based on good policy (questioned and cast doubt on B&D (2000) conclusions)
Economides et al	2004	17	Aid has a positive impact on growth, but the impact was reduced by the negative effects of recipient rent seeking

Authors	Year	Page	Conclusions
			activities, especially in recipient countries with a large bureaucracy
Heady et al	2004	3	Aid is more effective in countries recovering from economic shocks and in post conflict periods. Aid is less effective in countries at war or which are geographically disadvantaged
Ram	2004	208	No evidence to support the theory that aid to countries with good policy has positive impact on growth or policy reduction
Feeny	2005	1092	Found little evidence that aid has had a positive impact on growth in Papua New Guinea
Gomanee, Girma & Morrissey	2005	308	Aid has positive impact on welfare particularly in poor countries and irrespective of policy environment
Gomanee, Morrissey, Mosley & Verschoor	2005	355	Aid has a positive impact on welfare either directly or through the effect on growth (aid has positive impact on growth)
Islam	2005	1468	Aid can have a positive impact on growth but only in a stable political environment, irrespective of the quality of economic policies
McGillivray	2005	2	On average, has a positive impact on growth
Outtara & Strobl	2005	4	Project aid has a positive impact on growth while programme aid has a negative impact on growth and neither project aid nor programme aid are influenced by good policy environments
Rajan & Subramanian (2005b)	2005	2	Aid may not have a significant positive impact on growth because aid weakens public institutions (this offset any positive effects) also Knack (2001) and Brautigam & Knack (2004)
Burke, Fredoun, & Esfahani	2006	350	Aid had an insignificant impact on growth
Doucauliagos & Paldam	2006	26	Aid on average has not achieved its goal of generating growth or stimulating development.
Al-Khaldi	2008	16	Found that in Jordan foreign aid has a positive impact on growth

Authors	Year	Page	Conclusions
Mallik	2008	251	The long term impact of aid on growth is negative (for most countries)
Rajan & Subramanian	2008	643	Find little robust evidence of a positive or negative relationship between aid and growth (the impact of aid on growth is not positive or negative)
Dalgaard & Erickson	2009	1178	Aid does have the potential to have a positive impact on growth and poverty
Dalgaard & Hansen	2010	3	There is little consensus on the impact of aid on growth. The biggest problem lies with identifying the casual impact of aid on growth. This problem largely unsolved